Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
Access Charge Reform	)	CC Docket No. 96-262
Price Cap Performance Review for Local Exchange Carriers	)	CC Docket No. 94-1
Low-Volume Long Distance Users	)	CC Docket No. 99-249
Federal-State Joint Board on Universal Service	)	CC Docket No. 96-45

REPLY COMMENTS OF GTE

GTE SERVICE CORPORATION AND ITS AFFILIATED LOCAL EXCHANGE COMPANIES

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April 17, 2000

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SUMMARY

The Coalition for Affordable Local and Long Distance Service ("CALLS" or the "Coalition") presents the Commission with a unique historic opportunity to take significant strides to resolve more than two decades of bitter disputes that have accompanied the quest to resolve three thorny interrelated regulatory issues: universal service, subscriber line charges and access rates. While the CALLS plan does not completely or perfectly resolve every issue, it does represent a careful balance that achieves a remarkable number of competing goals. In these comments, GTE again urges the Commission to take the historic path toward tangible, public interest benefits. The record illustrates that CALLS enjoys wide support. A paper by Dr. Laura Tyson, former Chair of the President's Council of Economic Advisors and the National Economic Council, is attached which demonstrates the benefits of the CALLS proposal and the urgent need for reform.

Several naysayers, however, attempt to skew the balanced CALLS plan to their own selfish interests. A tiny number of commenters challenged the plan on process grounds either because all affected parties were not participants in the Coalition or that the CALLS proposal is the product of compromise. Not only do these commenters fail to point to any legal or procedural support that could undermine the legality of the procedures followed, their arguments ignore the important role these negotiations play. For one, the Commission has long recognized the value of the negotiation process to resolve difficult regulatory issues and produce regulatory stability. Moreover,

compromise is an important, if not essential, element in the regulatory process and has been used in countless rulemaking proceedings.

Other commenters express concerns that the failure to include all voices in the Coalition taints its proposal as unreasonable. This view ignores the fact that administrative procedures have been designed to include the opportunity for all interested parties to comment. Here, the interested public has had four separate opportunities to do so. In fact, this and other feedback led to the modifications to the CALLS proposal that are currently at issue.

As the Coalition briefs and comments, as well as a multitude of supportive commenting parties, have demonstrated, the CALLS modified proposal will produce a series of important and tangible benefits not only for consumers but also for the entire telecommunications industry.

For one, the CALLS proposal takes significant strides in establishing a sufficient, predictable, and explicit universal support mechanism. Initially, the proposal attacks major sources of implicit subsidy in interstate access charges support by reforming the common line rate structure. It then includes $650 million in interim support. Detractors' claims have no merit. The interim $650 million figure was determined via arms-length negotiations between parties with different economic interests but equal bargaining power, is sized between the various estimates of implicit support, and is based, in part, on UNE loop and port pricing. These techniques have produced interim results that are at least as predictable as the results generated by the current, implicit support structure. Finally, none of the commenters in this proceeding have offered any

convincing evidence that the fund should be different from the one proposed by CALLS.

The Commission should avoid further delays. GTE is not opposed to further informal consultation with the Federal-State Joint Board, provided it does not interfere with the July 1 implementation date. The Commission should also reject the argument that Section 254(k) prevents the Commission from rolling the PICC into the SLC. The Eighth Circuit has already found against this argument.

Another benefit of the CALLS plan is that it sets SLC caps at the levels necessary to permit ILEC recovery of common line costs while ensuring that rates remain affordable and comparable throughout the country. The modified CALLS proposal takes the original proposal two steps further by (1) lowering the SLC caps, and (2) giving the Commission the opportunity to review cost data after the SLC reaches $5. Alternative proposals for even lower SLC caps based on the Hybrid Cost Proxy Model or a forward-looking economic cost model are seriously flawed. Additionally, these proposals fail to address the link between SLCs and universal service funding. At bottom, the Coalition plan provides greater affordability and comparability of rates by fostering competition, particularly in rural and high-cost areas, through the creation of incentives and opportunities for competitive carriers to compete for all types of customers.

Finally, the switched access rate reductions contained in the modified CALLS proposal will provide both immediate and continuing benefits arising from significantly reduced long distance charges. First and foremost, the proposal guarantees benefits flowing from switched access rate reductions to take effect on July 1, 2000. In addition,

by targeting the X-factor productivity adjustment on switched access rates, the proposal will reduce these rates by almost 50% within the five-year duration of the CALLS plan. The CALLS plan will produce greater public interest benefits than would an equal allocation between flat-rate and minute-of-use ("MOU") pricing of access services.

Even with these substantial benefits, some continue to throw stones, rather than offering real solutions. First, some commenters assert that this approach is an arbitrary departure from existing price cap regulation. The assertion that there is no economic justification to depart from the present system of applying the X-factor equally to all price cap baskets fails to recognize that this same objection applied equally to the targeting of the TIC. In that case, the Commission expressly rejected this argument, noting in essence that the end to be achieved justified the means. In this case, it is entirely justifiable to accelerate price cap reductions for a specific service category or subcategory where the goal is to obtain a reasonable, pro-competitive end result.

Nor does the CALLS proposal's targeting of X-factor reductions to Average Traffic Sensitive rates constitute premature pricing flexibility. Far from granting ILECs premature pricing flexibility, the CALLS proposal retains the existing limitations on pricing flexibility contained in Section 61.47(e). Asserting that the CALLS plan's X-factor changes results in the creation of an arbitrary X-factor scheme is without merit. The CALLS proposal is simple, straightforward and, does not establish a multitude of X-factors. Finally, the assertion that the reduction of the X-factor to GDP-PI is arbitrary fails to properly acknowledge that this mechanism is entirely rational in the context of the entire CALLS proposal to achieve a certain end.

Second, several parties assert that the rate reductions for switched access are too steep and will thus inhibit entry of CLECs into the local exchange access market. However, a more gradual glide path to the CALLS target rate caps would merely mandate higher rates, and thus, provide CLECs with higher revenues for a transitory period. As Dr. Tyson points out in her analysis, this artificial revenue boost only encourages additional CLEC entry that is misguided and economically unsound in the long term. Instead, these CLECs are arguing that the Commission should allow them to endorse their practice of "umbrella pricing," i.e., pricing access services just below the rates offered by ILECs. This is wrong.

The CALLS proposal represents the Commission's best road map out of the regulatory thicket of three of the largest issues facing it today: universal service, subscriber line charges and access rates. The parties throwing rocks at this effort have missed the target. The procedure used is right and reasonable; attempts to derail the process by introducing side issues must be rebuffed. The public interest benefits to the CALLS plan are real, the plan will help consumers, and the holistic approach will bring competition to all sectors of the country. GTE strongly urges the Commission to take the right first step and adopt the CALLS plan as proposed.

DRAFT
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REPLY COMMENTS OF GTE

GTE Service Corporation and its affiliated local exchange carriers (collectively "GTE")[1] respectfully submit their Reply Comments to the Commission's Public Notice requesting supplemental comment on the proposal of the Coalition for Affordable Local and Long Distance Service ("CALLS" or the "Coalition").[2]

[1] GTE Alaska, Incorporated, GTE Arkansas Incorporated, GTE California Incorporated, GTE Florida Incorporated, GTE Hawaiian Telephone Company Incorporated, The Micronesian Telecommunications Corporation, GTE Midwest Incorporated, GTE North Incorporated, GTE Northwest Incorporated, GTE South Incorporated, GTE Southwest Incorporated, Contel of Minnesota, Inc., GTE West Coast Incorporated, Contel of the South, Inc., and GTE Communications Corporation.

[2] *Coalition for Affordable Local and Long Distance Services (CALLS) Modified Proposal*, DA 00-533 (Mar. 8, 2000) (Public Notice) *("Modified CALLS Notice");* deadlines extended in *Coalition for Affordable Local and Long Distance Services (CALLS) Modified Proposal*, DA 00-692 (Mar. 24, 2000) (Public Notice). Unless

(Continued...)

The Coalition has presented the Commission with a unique historic opportunity: the chance to ameliorate more than two decades of bitter disputes that have accompanied the quest to resolve three thorny interrelated regulatory issues: universal service, subscriber line charges and access rates. The CALLS plans, both the original plan proposed on July 29, 1999 and the modified plan presented on March 8, 2000, are attempts by a group of local exchange carriers and interexchange carriers to propose a comprehensive, balanced holistic response to these competing policy interests. In these comments, GTE again urges the FCC to adopt as proposed the CALLS comprehensive plan for access pricing and universal service protections.

As an initial matter, those parties that allege the process by which the CALLS plan was developed is inherently flawed are wrong. The CALLS process is a well-established means of developing consensus on these difficult issues. In fact, the proposal represents not only the consensus of opinion among previously adverse parties but also the surest route to a far-reaching, pro-competitive response to these long debated issues. Finally, the Commission should not be distracted by the laundry list of pet issues other parties attempt to link to CALLS. The issues confronted here are difficult enough without these distractions that are already being addressed by the Commission in other proceedings.

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otherwise noted, all comments cited herein were filed in CC Docket No. 96-262, et al. on April 3, 2000.

I. THE CALLS PROPOSAL PRESENTS THE BEST PATH OUT OF THE PRESENT REGULATORY THICKET INTO THE FIELDS OF OPEN COMPETITION.

The Commission has reached a critical crossroads where the future of many intransigent access, price cap, and universal service issues can be substantially addressed in a harmonious fashion. This type of historic decisionmaking opportunity comes very rarely: the last one occurred over 20 years ago.[3] At this junction there are two critical choices. One path leads to broad industry consensus where the Commission can resolve a huge number of outstanding proceedings and move toward the creation of a stable regulatory landscape and the open competitive environment that the 1996 Act seeks to achieve. The other path only continues the journey through the current thicket of numerous, protracted proceedings with multiple rounds of litigation, ending with uncertainty and little progress for all.

GTE urges the Commission to adopt the CALLS proposal, as modified on March 8, 2000, in order to take the historic path toward tangible, public interest benefits. The Commission should reject the attempts of several naysayers, some of whom have belatedly come out of the weeds along the path, in an attempt to skew the balanced CALLS plan to their own selfish interests. The CALLS plan is the result of many months of hard work and serious compromise by a coalition of the major IXC and ILEC players. Although the comprehensive CALLS plan does not completely or perfectly resolve every issue, it does represent a careful balance that achieves a remarkable number of competing goals that is the best anyone, including the Commission, has

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[3] *Exchange Network Facilities for Interstate Access (ENFIA)*, 71 F.C.C.2d 440, 443 (1979) ("*ENFIA Order*").

been able to offer to date. The compromise, transition plan has been open to detailed scrutiny through several public comment rounds and numerous public forums. This plan has been further improved after taking into consideration issues raised by the parties, including the FCC, state commissions and their staffs, and residential and business end users. GTE believes that there is not, and no party on this record has offered, a better alternative path to settlement.

As the Coalition briefs and comments, as well as a multitude of supportive commenting parties, have demonstrated, the CALLS modified proposal will produce a series of important and tangible benefits not only for consumers but also for the entire telecommunications industry. The modified plan will:

- support affordable interstate end-user rates, particularly for customers in rural and high-cost areas and low income customers;
- reduce consumer long distance rates;
- simplify customer bills;
- rationalize and stabilize price cap interstate access rate structure and levels for participating price cap carriers;
- promote competition and create a market environment where intrusive regulation is eventually unnecessary;
- promote facilities-based competition in urban and rural areas by both ILECs and CLECs;
- provide investment stability during this critical five-year period in the development of telecommunications competition; and
- create a more explicit, nondiscriminatory universal service support mechanism.

GTE strongly urges the Commission to take the right step now, and choose the path of the modified CALLS plan so that it can immediately create these important public policy results, with the stability and efficiency that only a balanced compromise can bring. Indeed, the 1996 Telecommunications Act requires the FCC to make this effort.

II. THE USE OF BROAD-BASED AGREEMENTS AMONG MAJOR PARTIES IS AN ACCEPTABLE AND REASONABLE METHOD TO RESOLVE DIFFICULT POLICY ISSUES.

A tiny number of commenters raise concerns regarding the process used to develop the proposed CALLS plan. Specifically, these commenters challenge the plan either because all affected parties were not participants in the Coalition[4] or that the CALLS proposal is the product of compromise.[5] Yet, one point is very clear, the process has been open. The fact that comments were solicited and filed belies any argument that the CALLS proposal has been insulated from the input of non-Coalition members. Additionally, input from interested parties during multiple comment rounds has had an impact, given that the proposal has been modified in response to the first round of comments.[6] Significantly, these commenters raise no legal or procedural basis that could undermine the legality of the procedures followed. Moreover, the Commission will conduct its own assessment of the public interest aspects of the proposal and it is that decision which is relevant – not the initial submission.

A. Using Negotiated Settlements and Compromise Is a Recognized Method to Resolve Difficult Policy Issues.

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4 *See, e.g.,* Comments of Allegiance Telecom, at 2 (competitive carriers not part of the Coalition) ("Allegiance Comments").

5 *See* Joint Comments of Ass'n. for Local Telecom. Services and Time Warner Telecom, at 2, 5-6 (calling the proposal a "highly flawed deal") ("ALTS/Time Warner Comments").

6 Memorandum in Support of the Revised Plan of the Coalition for Affordable Local and Long Distance Service ("CALLS"), CC Docket 96-262 et al., at 4 (filed Mar. 8, 2000) ("Revised Plan Memorandum").

As an initial matter, the Commission has long recognized the value that the negotiation process can bring to resolve difficult regulatory issues, in formulating a proposal for Commission consideration. The Commission has found that the negotiation process is "a reasonable means of avoiding complex and protracted litigation of hotly contested issues among historically litigious parties, [and] as conducive to the ends of justice, and therefore, … in the public interest."[7] By solving thorny issues, and by producing regulatory stability through consensus and agreement, the negotiation process has the additional benefit of eliminating the costs associated with regulatory uncertainty.[8]

Indeed, recognizing these benefits the Commission itself has initiated such a process. For example, over twenty years ago, the Commission "convened meetings among the interested parties to determine whether an interim negotiated settlement could be reached" to resolve issues regarding the compensation for the use of local carrier's exchange facilities.[9] That process was successful.

Despite this history, Time Warner and ALTS take the unsupported position that proposals formulated through negotiations, such as the CALLS plan, "always contain accommodations to the specific interests of the negotiating parties that would not

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7 *ENFIA Order* at 456.

8 *See* Dr. Laura Tyson, Comments on the Proposal by the Coalition for Affordable Local and Long Distance Service, CC Docket No. 96-262 et. al, Exhibit A, at 24 (filed Apr. 17, 2000) ("*Tyson Study*"). Dr. Tyson is Dean of the Haas School of Business at the University of California, Berkeley and was the former Chair of the President's Council of Economic Advisors and the National Economic Council.

9 *ENFIA Order* at 443.

survive independent regulatory review."[10] Nothing could be further from the truth. In the ENFIA proceeding, the Commission requested comment from the public regarding the agreement and conducted its own assessment of "the public interest and not the signing parties' and commenting parties' more individual interests."[11] In the end, the Commission found the negotiated agreement to be in the public interest and approved it. The current proceeding is no different. Here, a proposal has been formulated through negotiations, the Commission has requested public comment about the CALLS plan, and will ultimately conduct the public interest review and evaluation required by the Administrative Procedure Act ("APA").[12] Such a procedure is fully consistent with the law.

Finally, Time Warner and ALTS infer that the process is somehow inherently flawed because it is the result of compromise between private parties.[13] Compromise is an important, if not essential, element in the regulatory process. The Commission has explicitly made countless compromises in its rulemaking proceedings over the years.[14]

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10 ALTS/Time Warner Comments at 2.

11 *ENFIA Order* at 451.

12 *See Access Charge Reform*, FCC 99-235, ¶ 5 (Sept. 15, 1999) (Notice of Proposed Rulemaking) ("*CALLS NPRM*").

13 *See* ALTS/Time Warner Comments at 2.

14 *See, e.g.*, *Communications Assistance for Law Enforcement Act*, 14 FCC Rcd 16794, 16835-36 (1999) (using compromise to set standards for call-identifying messages); *Amendment of the Commission's Rules to Establish New Narrowband Personal Communications Services*, 9 FCC Rcd 1309, 1311 (1994) (using compromise to designate channels for use by Personal Communications Services); *Amendment of Part 36 of the Commission's Rules and Establishment of a Joint Board*, 9 FCC Rcd 334, 334 (1993) (using compromise to establish a universal service level).

Without compromise, no real solutions to intractable problems can be attained. Again, the ENFIA proceeding is illustrative. There, the Commission not only anticipated, but fully expected, the parties to arrive "at some form of a 'rough justice' interim approach" to resolve the issues put before them.[15] In short, compromise is not inherently bad, but rather, is essential in resolving protracted disputes.[16]

B. The Reasonableness of the CALLS Plan Is Not Dependent Upon the Size or the Specific Composition of the Membership of the Coalition Particularly Since Administrative Procedures Ensure that All Views Will Be Recognized.

Other commenters, such as Allegiance, express the concern that the absence of certain interest groups from the Coalition taints the CALLS proposal as unreasonable. They suggest that the lack of these specific voices means that not all positions will be reflected in the plan and that more participants are always better. This is simply not the case. The public comment process ensures that all views will be heard.

Administrative procedures that 'make law' have been designed to ensure that all interested parties have a voice. The APA[17] and the Communications Act[18] require that revisions such as those proposed in the CALLS plan are open to public notice and

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15 *ENFIA Order* at 443.

16 *See Review of the Commission's Regulations Governing Television Broadcasting; Television Satellite Stations Review of Policy and Rules*, 14 FCC Rcd 12903, 12989 (1999) (Statement of Commissioner Michael Powell) ("Rules, however, are by their very nature both under- and over-inclusive. The rules we adopt today are not all right, and not all wrong. But they reflect what good public policy often must be, a balanced compromise of conflicting values and judgments.").

17 *See* 5 U.S.C. § 553.

18 47 U.S.C. § 154(j).

comment. Pursuant to the APA, all interested parties have had significant opportunities, and have taken advantage of the opportunities, to express their views. The Commission has placed the CALLS plan on public notice and requested comment from the public on two different occasions.[19] In all, the interested public has had four separate opportunities to bring comment before the Commission on a formal basis. Additionally, a number of parties have used the opportunity presented by the Commission's *ex parte* rules to bring other issues and concerns to the attention of the Commission. In fact, the notice and comment procedure, as well as other feedback, led to the modifications to the CALLS proposal that are at issue in this current round of public comment.[20]

This notice and comment requirement invariably influenced the initial formation of the Coalition and plan. As an initial matter, while not every possible party was a member of the Coalition, CALLS did represent an unusually broad range of interests. In addition, understanding and appreciating the need for widespread approval, the CALLS membership necessarily needed to account for the views of those parties not actually part of the Coalition if the Coalition wanted its proposal to survive the public hearing process intact. Moreover, given the holistic nature of the proposal, the incentives to compensate for all views to preserve the integrity of the plan was intense. This led the CALLS membership to consult with interested non-members throughout the initial development of the CALLS proposal, and continuing through the

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19 *See CALLS NPRM; Modified CALLS Notice*.

20 Revised Plan Memorandum at 4.

administrative process. Thus, in a real sense, the interests of parties not actually members of the Coalition were represented as the plan was being developed and before it was presented to the Commission for consideration.

At bottom, the use of broad-based agreements among major parties is an advantageous method by which the Commission can address difficult, and thorny regulatory conflicts. There is nothing underhanded or even sneaky about this process because the Commission must undertake an open, public evaluation of the public interest issues. It is this final evaluation, not the composition of the group, its membership or size, that ultimately determines whether the output of that consensus satisfies the public interest. Given the fact that the process is sound, GTE urges the Commission to consider the public interest benefits that will result from the CALLS proposals as illustrated below.

III. THE MODIFIED PLAN ESTABLISHES A SUFFICIENT, PREDICTABLE, AND EXPLICIT INTERIM SUPPORT MECHANISM CONSISTENT WITH SECTION 254 OF THE ACT.

The Commission is obligated under the Act to design a universal service program that is sufficient, predictable, and explicit.[21] The CALLS proposal takes significant strides in establishing such a universal support mechanism. First, the proposal attacks major sources of implicit universal service in interstate access charges

[21] *See, e.g.*, *Federal-State Joint Board on Universal Service*, FCC 99-306, ¶ 1 (Nov. 2, 1999) (Ninth Report & Order and Eighteenth Order on Reconsideration) (*"Ninth Report & Order"*) (noting that Section 254 instructs the Commission "to establish specific, predictable, and sufficient mechanisms to preserve and advance universal service").

support by reforming the common line rate structure. As Dr. Laura Tyson demonstrates in her comments, artificially inflated access charges lead to distortions in allocation, as customers change their habits from what they would otherwise prefer. Artificially high charges also create a price umbrella that allows competitors to enter the market even if they are non-efficient producers or are charging premium prices.[22] Second, the CALLS proposal includes $650 million in explicit support targeted to high cost areas during the five-year transition period.[23]

The Commission should not be distracted off of the proper path by the claims put forth by other commenters that the Joint Board on Universal Service should be consulted on this matter or that it implicates Section 254(k). Both claims are misplaced. The CALLS plan deals entirely with interstate access charges and does not implicate state issues. The commenters that raise Section 254(k) claims ignore the fact that the Eighth Circuit has already held that this section does not require loop costs to be billed to any particular service providers.

A. The Proposed Interim $650 Million Interstate Access USF Fund for the Transition Period Is Supported by the Record.

As the Coalition has demonstrated previously, $650 million represents a reasonably sized fund during the five-year transitional period when this interim plan is implemented. The Coalition is made up of a variety of parties from a cross-section of the telecommunications industry. It includes entities that are largely net recipients of

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22 *See Tyson Study* at 9.

23 In an earlier proceeding, GTE estimated the amount of implicit support generated annually by interstate access rates at $5.9 billion annually.

universal service, such as some ILECs, as well as entities that are largely net contributors to the universal service fund, such as interexchange carriers like AT&T and Sprint. The size of the $650 million interstate access universal service support fund for the transitional period was decided through arms-length negotiations between these parties with diametrically opposed economic interests and equal bargaining power. As a result of this balance, the estimate is fundamentally conservative, and no commenters have presented any evidence to the contrary.

Indeed, the CALLS plan creates a fund sized in between various estimates of the current level of implicit universal service support. The USTA, for example, submits that the current level of implicit support is $3.9 billion.[24] An FCC staff study by Rogerson and Kwerel estimated the figure is $1.9 billion,[25] while the HAI model projects a forward-looking estimate of implicit universal support at $250 million.[26] Rather than litigate this issue, the CALLS members negotiated a reasonable, interim solution after considering all the complex issues associated with interstate universal service reform.

The CALLS fund will also help promote the affordability of basic telephone service.[27] In her comments, Dr. Tyson shows that some form of universal service fund

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[24] *See* Comments of the United States Telephone Association ("USTA"), CC Docket No. 96-45 and 96-262 (filed July 23, 1999).

[25] *See* William Rogerson and Even Kwerel, CC Docket No. 96-45 and 96-262, at 15-16 (filed May 27, 1999).

[26] *See* HAI Model Version 5.0a, CC Docket No. 96-45.

[27] The CALLS fund, however, is just one component of universal service – it is intended to address implicit supports in interstate rates, not intrastate rates.

will always be necessary.[28] Simply raising the SLC cap would not be enough to provide for universal service, since the cost of providing service in many areas of the country will continue to exceed monthly charges. The CALLS plan accommodates the need for universal service, while providing an immediate decrease in average customer costs. Even after the SLC increases are implemented, Dr. Tyson shows that the real cost to consumers of telephone service will remain much lower than it was ten years ago.[29]

The manner in which the CALLS plan was negotiated ensures the basic fairness of the settlement. For example, two Coalition members, AT&T and Sprint, are net contributors to the universal service fund. These companies have every incentive to keep the size of the fund (and, consequently, the size of their contributions) as small as possible. No commenter has suggested that these companies are unable to represent the economic interests of interexchange carriers in the CALLS proceeding. Indeed, given the size and sophistication of these entities, any such suggestion would be ludicrous. In fact, MCI, which was not part of the CALLS negotiations, has stated that the size of the fund is acceptable.[30] The divided point of view of commenters, with some saying that the number is too high and others claiming that it is too low, tends to provide further evidence that the CALLS proposal should be accepted by the Commission for the transitional period.[31]

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28 *See Tyson Study* at 22.

29 *Id.* at 22-23.

30 *See* Comments of MCI WorldCom, Inc., CC Docket No. 96-262, et al., at 11 (filed Nov. 12, 1999).

31 *See ENFIA Order* at 451.

1. No Commenters Have Presented Credible Alternatives to the Size of the CALLS Proposal.

Furthermore, none of the commenters in this proceeding have offered any convincing evidence that the fund for the five-year transitional period should be a size other than the one proposed by CALLS. ALTS' suggestion that the fund should be $300 million appears to be a number simply pulled from thin air.[32] The other suggestion by ALTS, that AT&T's $613 million estimate should not be rounded to $650 million, misses the point.[33] The CALLS estimate was not arrived at using forward-looking economic cost ("FLEC") methodology, as the CALLS filing clearly indicates.[34] Rather, AT&T's FLEC estimate was advanced by AT&T as merely another indication of support for the CALLS figure.

Finally, the FCC should not consider any arguments that commenters raise for the first time in the reply round of this proceeding.[35] The parties to this proceeding have had more than enough time to gather evidence and make their position known to the Commission during the standard prescribed comment period. There is no reason to inject further delay and uncertainty into this process by allowing parties to raise new issues at this late stage.

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32 *See id* at 4.

33 *See* ALTS/Time Warner Comments at 16.

34 *See* Revised Plan Memorandum at 10.

35 *See* Allegiance Comments at 2. Allegiance states that it will "address [potential] changes [to the size of the fund] in its reply comments."

B. The Modified Plan's Targeting Mechanism Strikes an Appropriate Balance Between Ensuring that High Cost Areas Receive Appropriate Support and Making Sure the Fund Remains a Reasonable Size.

The modified plan bases support amounts, in part, on UNE loop and port pricing, by distributing support amounts to higher cost UNE zones. This methodology produces results that are at least as predictable as the results generated by the current, implicit support structure. Moreover, the CALLS plan ensures that universal service amounts and UNE loop rates are closely tied.

Matching universal service amounts to UNE zones avoids regulatory arbitrage by preventing ILECs from receiving universal support amounts based on significant deaveraging while at the same time charging UNE loop costs that are highly averaged. If universal service is not tied to UNE zones, then the cost and support amounts would be out of balance and result in the insulation of high-cost zones from competitive entry. The CALLS plan, on the other hand, promotes consistency and predictability.

C. There Is No Need to Delay the CALLS Proposal for Further Federal-State Consultations, Since These Universal Service Issues Have Been Left for FCC Decision by the Joint Board.

Some state commenters want the FCC to consult with the Federal-State Joint Board prior to adopting CALLS. While GTE would not be opposed to a further informal consultation with the Joint Board that would not interfere with the July 1 implementation date, since the Joint Board has already reviewed these issues, such a consultation is not necessary and is certainly not a legal requirement. The universal support mechanism in the CALLS plan relates solely to implicit support in *interstate* access charges, and the Joint Board has already considered these issues twice on prior

occasions. The first referral dealt generally with the creation of explicit universal service support programs.[36] The second dealt specifically with one of the issues raised in the CALLS proposal, and asked the Joint Board whether interstate access charges should be reduced to reflect the transition from implicit to explicit support.[37] The Joint Board considered the matter and found that it is within the Commission's discretion to determine the level of implicit support in access rates and propose a method of making the support explicit.[38] Therefore, while GTE expects consultations to continue as they have in the past, further consultation should not be used to delay implementation of the CALLS proposal.

Finally, the six points that NARUC urges the FCC to consider when reviewing the modified CALLS proposal are each already addressed by the plan.[39] The filings submitted by the Coalition throughout this proceeding demonstrate in detail the benefits that end-users will enjoy as a result of the plan, as well as the proposal's consistency with the 1996 Act.[40] As a comprehensive package of reforms negotiated by participants

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[36] *Federal State Joint Board on Universal Service*, 12 FCC Rcd 87 (1996) (Recommended Decision).

[37] *Federal State Joint Board on Universal Service,* 13 FCC Rcd 13749 (1998) (Order and Order on Reconsideration).

[38] *Federal State Joint Board on Universal Service*, 13 FCC Rcd 24744, 24755 (1998) (Second Recommended Decision).

[39] *See* Comments of the National Ass'n. of Rural Utilities Commissioners at 2 ("NARUC Comments").

[40] The previous comments of CALLS also show careful consideration of the other concerns that NARUC raises: potential impact on jurisdictional allocation of costs, accommodation of the interests of affordability and comparability, the impact of the Internet on the Plan, as well as the merits of market based versus prescriptive

(Continued...)

from every sector of the telecommunications industry, the CALLS proposal includes discussion and resolution of all of these important elements of interstate access charge and universal service reform.

D. The Eighth Circuit Has Already Ruled That Section 254(k) Does Not Require Loop Costs Be Billed to Particular Service Providers.

Some commenters argue that Section 254(k) prevents the Commission from rolling the presubscribed interexchange carrier charge ("PICC") into the SLC, since this would allegedly combine supported and unsupported elements and pose a danger of cross-subsidization.[41] These commenters, however, fail to even acknowledge the existence of an Eighth Circuit holding which directly counters their argument, even though this precedent was brought to their attention in earlier rounds. In *Southwestern Bell Telephone Co. v. FCC*,[42] the Eighth Circuit held that the SLC is a method of recovering loop costs, rather than a way of apportioning loop costs between services that are supported by universal service and those that are not. Since the subscriber causes local loop costs simply by requesting telephone service, whether the loop is used for inter- or intrastate calls, the court found that it was appropriate to recover

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approaches. S*ee, e.g.,* Revised Plan Memorandum at 3-5, 8-10, 12; Comments of the Coalition for Affordable Local and Long Distance, CC Docket No. 96-262, et al., at 3, 7-8, 10, (filed November 12, 1999).

41 *See* Comments of Montana Public Service Commission, at 3; Comments of National Telephone Cooperative & National Rural Telecom Ass'n., at 14-16; Supplemental Comments of National Ass'n. of State Utility Consumer Advocates, at 21 ("NASUCA Comments"); Comments of The Public Service Commission of Wisconsin, at 5.

42 153 F.3d 523 (8th Cir. 1998).

these charges directly from the end user. Given this reasoning, Section 254(k) is simply not implicated when costs are recovered through the SLC, and federal law does not require the permanent retention of the confusing PICC in order to split cost recovery between specific providers. At bottom, the Commission should give no weight to arguments that have already been considered and rejected by the Eighth Circuit.

IV. CALLS' MODIFIED SLC RESTRUCTURING IS IN THE PUBLIC INTEREST AND WILL ACHIEVE CONSUMER BENEFITS.

The Commission's current rules, adopted in 1997, already provide for a transition to recovery of interstate common line costs through flat charges, thus eliminating the usage-based CCL charge. The original CALLs plan proposed to further reform the structure of interstate common line rates by eliminating the PICC for primary and non-primary lines immediately, by phasing out the PICC for multiline business over time, and by eliminating the CCL more rapidly. Where flat-rate common line charges might otherwise be unaffordable, a new universal service fund would provide explicit, portable support, which in turn would help maintain caps of $7 and $9.20 for single-line and multiline rates, respectively. The new, combined SLC charge for single line customers was to begin at $5.50, which is the level most customers are paying today for the SLC and the passthrough of PICC charges by IXCs. Subsequent increases in the SLC would have closely paralleled the increases in PICC charges already adopted in the Commission's rules. This original CALLS proposal would have improved the efficiency of common line recovery, promoted the development of efficient competition, and simplified customers' bills. At the same time, it would have ensured that SLC rates remained both affordable and reasonably comparable. The modified CALLS proposal

responds to concerns raised by other parties by striking a different policy balance. The cap on the new SLC charge for single-line customers will be lower, throughout the life of the plan, than under the original CALLS proposal. This ensures that monthly flat rates will be even more affordable, and that rates in different areas will be even more comparable. Because the SLCs increase more slowly under the modified plan, the gains in efficiency and promoting competition will be achieved more gradually than under the original proposal, but will still be significant, as Dr. Tyson makes clear in her study.[43]

It is important to note that many of the concerns raised as "new" by parties commenting on the modified CALLS proposal are in fact recycled from earlier proceedings and litigation in which these issues have been thoroughly examined, and settled. The current rules base common line recovery on the Commission's price cap mechanism; they will eliminate usage-based interstate common line recovery and replace it with flat charges; they will result, in some places, in recovery entirely through SLC charges, with no charges to IXCs; and they already allow for rates to differ by geography. Yet some parties persist in raising again questions which have been asked and answered.

A. Limiting the SLC Cap to a Lower Level Will Fail To Achieve Adequate Cost Recovery.

The CALLS plan bases common line recovery on the amounts that the FCC currently allows ILECs to recover and is therefore a legitimate and reasonable basis

[43] *See Tyson Study* at 21.

upon which to base the plan. Under rate of return regulation, which the Commission abandoned in 1990, ILECs were given the opportunity to recover their embedded costs. In the ten years since the implementation of price cap regulation, however, prices have not been tied to a rate of return calculation. Rather, prices have been established on the basis of the price cap formulas that lower access charges each year.

The FCC has repeatedly found that price caps, which provide the basis for the recovery level in CALLS, have maintained access charges at reasonable levels. Initially, the Commission set the price cap index at a level based upon rates in effect on July 1, 1990, which it explicitly held to be reasonable.[44] In fact, the Commission found that the July 1, 1990 rates were in general "the best that rate of return regulation can produce."[45] Moreover, since January 1, 1991, access rate ceilings have been adjusted downward each year by application of the X-factor. In addition, the FCC has ordered additional reductions in access charges.[46] Consequently, price caps and thus access charges have fallen by more than 50% since 1991.[47] Throughout this period, access

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[44] *See, e.g., Policy and Rules Concerning Rates and Dominant Carriers,* 5 FCC Rcd 6786, 6814-16 (1990) ("*LEC Price Cap Order*").

[45] *Id.* at 6815.

[46] *See, e.g.*, *Access Charge Reform,* 12 FCC Rcd 15982, 16111-18 (1997) (First Report and Order) (*"Access Reform Order")* (ordering ILECs to make an exogenous cost decrease to account for the completion of amortization of equal access charges).

[47] *See* Comments of William E. Taylor, Attached to Comments of USTA, CC Docket No. 96-262, *et al.,* at 16 (filed Oct. 29, 1999).

charges have remained at levels consistent with the Commission's plan. And they are at reasonable levels today.[48]

On the other hand, common line recovery cannot legitimately be based on the Hybrid Cost Proxy Model. The FCC adopted the model only for determining the relative portion of state cost support to allocate among states. The FCC itself expressed doubt that it would be appropriate to use that cost model in any other context.[49]

Moreover, the arbitrary downward adjustment to common-line recovery advocated by some commentators – whether based on model estimates or any other method – is particularly inappropriate because it represents bad economic policy and precludes ILEC recovery of the actual costs of providing access services. If the Commission adopts a policy that deprives ILECs of the ability to recover their actual costs, it will thwart the reasonable expectations in place at the time the investments were made. As a result, the FCC would have to address the inevitable takings claims seeking recovery of just compensation for stranded investments.[50]

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[48] In fact, because the X-factor has been overstated since 1991, access charges are now *below* levels that would be reasonable under the price cap plan adopted by the Commission in 1990. For example, under one analysis the present 6.5% X-factor is more than 2.44% above the measured productivity rate of 4.06% over the past five years. *See* Reply Comments of the United States Telecom Ass'n., CC Docket No. 96-262 et al., (filed Nov. 29, 1999), Attachment 3, Professor Frank M. Gollop, *Economic Evaluation of "Q" Factor Proposed by AT&T*, at 2 (Nov. 22, 1999).

[49] *See Ninth Report & Order* at ¶ 41. "[T]he federal cost model was developed for the purpose of determining federal universal service support, and [] it may not be appropriate to use nationwide values for other purposes . . . ."

[50] *See, e.g.*, *Connolly v. Pension Benefit Guaranty Corp.*, 475 U.S. 211, 225 (1986) (holding that, to establish a taking by a federal agency in violation of the Fifth Amendment, the plaintiff must show "(1) the extent to which regulation has interfered with distinct investment-backed expectations; (2) the character of the government

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Additionally, the Texas Public Counsel/CFA/CU (Texas Counsel) analysis is fatally flawed, and cannot be relied upon to establish cost recovery levels. The Texas Counsel would reduce subscriber line charges and eliminate PICC charges immediately. This proposal is problematic both for competition and universal service. The Texas Counsel plan does not address universal service funding to replace implicit universal service support currently in interstate access charges. It also does not call for deaveraging of rates. In fact, the SLCs produced by the Texas Counsel plan are even below the interstate share of the forward-looking cost predicted by the FCC's existing Hybrid Cost Proxy Model in many wire centers. This result would severely undermine the very competition that Congress and the Commission seek to promote.

On the other hand, the ALTS/Time Warner plan low-balls the estimates in the record for implicit support. This approach is no better. Compared with the Modified CALLS plan, the use of too low an estimate by the ALTS/Time Warner plan will harm rural customers.

Finally, the LEC members of CALLS have committed to providing data on the cost associated with the provision of retail voice service, by UNE zone, after the SLC cap has reached $5.00. If, after reviewing these data, the Commission finds that it wishes to alter the relationship between SLCs and other forms of common line recovery in certain zones, it can set different caps for those zones. However, because the current level of common line recovery is reasonable, and because SLCs are, as the

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action: and (3) the economic impact of the regulation on the claimant.")

Commission has long recognized, the most efficient means for recovering those costs, any further reductions in the SLC caps will perpetuate less efficient recovery through the existing PICC and CCL charges.

B. CALLS Benefits the Public Interest.

Some parties argue that geographic deaveraging of SLC rates will undermine the comparability of rates.[51] This argument reflects a misunderstanding of the Plan. The CALLS plan provides greater affordability and comparability of rates than current FCC rules do. The CALLS plan fosters competition, which, together with geographic deaveraging and the universal service fund, will help ensure that rates continue to be affordable and comparable.

1. Affordability and comparability of rates is maintained better under the CALLS' proposal than under the current FCC rules.

Affordability of rates is better maintained under the CALLS' proposal than under FCC's current rules. For example, the CALLS plan caps SLC rates at levels *lower* than customers would *currently* be paying. Today, single-line customers pay a SLC of $3.50 plus an average PICC pass-through charge of $1.50, for a total monthly flat-rate charge of $5.00.[52] In July 2000, the PICC is scheduled to increase by 50 cents, resulting in a new total monthly flat-rate charge of $5.50. The CALLS SLC cap, however, starts at

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[51] See NASUCA Comments at 3-4; Comments of Wyoming Public Service Commission, at 6, 8; NARUC Comments at Appendix A.

[52] The current PICC charge cap for single-line customers is $1.04. The pass-through of this charge by IXCs reflects costs of administration, billing, and uncollectibles, as well as the averaging of recovery across primary and non-primary lines.

$4.35. This figure reflects the fact that the modified CALLS plan reduces SLC caps and reduces the SLC cap increases, ensuring even greater affordability than the original plan. Finally, simply because the SLC cap increases over time does not mean that rates will increase to the same extent. The estimated average primary SLC at the end of the plan is $5.80, only 30 cents more than the combined flat rate amount customers would be paying on July 1, 2000 in the absence of CALLS. Thus, the average flat rate charge under CALLS will decline significantly on July 1, compared to what customers would pay under the current rules, and, at the end of the plan, the scheduled increases in the SLC would result in a charge only slightly higher than current rules would have called for in the first year.[53]

The CALLS proposal also maintains comparability of rates better than current FCC rules. Existing rules provide for further increases in the PICC charge of 50 cents (plus inflation) per year. Unlike the CALLS plan, there is no upper limit to these increases. Rather, the increases continue until the rates recover the common line revenues allowed under the price cap. Since common line revenues are higher in high-cost areas, by 2003, the sum of the SLC and the PICC pass-through from the interexchange carrier under current Commission rules could well reach levels comparable to the highest SLC allowed under the CALLS plan for low-cost areas, and would be considerably higher in high-cost areas. The SLC caps under the CALLS plan

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[53] These figures do not include other benefits resulting from the elimination of minimum usage by IXCs, from lower per-minute charges for long distance service, or from the enhanced Lifeline benefit under CALLS.

minimize this difference between low-cost and high-cost areas, ensuring more comparable common line rates.

PICC charges in some of GTE's higher cost study areas will exceed $4.80 for primary lines, and $12 for multiline business. In many lower-cost areas, these PICC charges will be zero. This will result in a greater disparity of flat-rate charges than would be created under the CALLS plan.

2. CALLS is beneficial because maintaining a lower cap will substantially inflate the size of the needed universal service fund.

The CALLS proposal reduces implicit subsidies in part by realigning rates, and in part through the new explicit universal service mechanism. To the extent that rate recovery is not reformed, the need for explicit universal service funding will be increased. The CALLs proposal represents a reasonable balance between rate reform and universal service. It will result in SLC rates that are both affordable and reasonably comparable. If the Commission were to adopt lower SLC caps, it would increase the burden of universal service funding that will have to be provided.

3. CALLS promotes competition because relying on common line cost recovery from SLCs does not insulate rates from competitive forces.

The CALLS proposal will foster competition, particularly in rural and high-cost areas, by creating incentives and opportunities for competitive carriers to compete for all types of customers. For one, CLECs are not required to impose SLC charges, thereby encouraging them to compete for residential and single-line business customers. Also, geographic deaveraging heightens CLEC incentives to compete in

rural and high-cost areas. Finally, CLEC competition in high-cost areas is encouraged by the fact that a significant portion of previously implicit subsidies are made explicit under the CALLS' plan, and are portable to all competitors.

Carriers that might seek to take advantage of the opportunity to charge higher rates in high-cost areas will be more likely to face competition from CLECs, which are not required to impose SLC charges. Moreover, since ILECs are not required to price SLCs at the cap, these competitive forces will help keep SLC charges down.

4. Deaveraging SLC rates is in the public interest.

Under the CALLS plan, carriers may deaverage SLCs based upon variations in state-approved prices for UNE loops and ports. The FCC has already found that deaveraging SLC rates is in the public interest.[54] Claims that the plan unreasonably discriminates against customers in high-cost zones are mistaken. In the absence of voluntary reductions, the difference between the SLC in the highest zone and the SLCs in the lower cost zone will be less than the difference in state-approved UNE prices. Further, because the CALLS plan provides for $650 million in targeted universal service support to rural areas, rural customers pay a much smaller share of the cost of providing service than urban customers do.

As noted above, the average primary SLC charge at the end of the CALLS plan is estimated to be about $5.80. The maximum primary SLC charge permitted in any zone is $6.50. Thus, the highest primary SLC will exceed the national average by only

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[54] *See Access Charge Reform*, 14 FCC Rcd 14221, 14252-53 (1999) (Fifth Report and Order and Notice of Proposed Rulemaking) (*"Pricing Flexibility Order")*.

70 cents, or about 12 percent. In its earlier proceeding on the high cost fund, the Commission assumed that rates within 35 percent of the nationwide average would be reasonably comparable. Vermont is thus simply incorrect when it suggests that CALLS would lead to SLCs that are not reasonably comparable.[55] Further, as shown above, this range of SLC rates is actually smaller than the range of the sum of the SLC and PICC charges that would occur under the current rules.

The CALLS plan is also in compliance with Section 254(g). That section provides that "rates charged by" providers of "interstate interexchange service" must be no higher in urban areas than in rural areas, and that they be no higher in one state than another.[56] Historic FCC geographic rate averaging and rate integration policies applied only to interexchange service itself, not to exchange access, whether paid by the carrier or the end user.[57] Loop costs are incurred by ILECs, not IXCs. PICC charges, as part of ILEC recovery of loop costs, are not forever transformed into IXC costs simply because the PICCs were passed on to IXCs. Thus, incorporating PICC charges into the SLC does not transform the SLC into a "rate charged by" IXCs, and Section 254(g) does not apply. In any event, under the current rules, SLCs and PICCs already vary from one geographic area to another. Therefore, if the claims that CALLS

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55 Vermont Comments at Section V.

56 47 U.S.C. § 254(g).

57 *See Integration of the Rates and Services for the Provision of Communications by Authorized Common Carriers between the United States Mainland and the Offshore Points of Hawaii, Alaska and Puerto Rico/Virgin Islands*, 61 F.C.C.2d 380 (1976).

violates Section 254(g) were valid, then the current rate structure would be illegal, which is clearly not the case.

V. CALLS TARGETED SWITCHED ACCESS RATE REDUCTIONS AND TARGET LEVELS ARE REASONABLE AND WILL PRODUCE SIGNIFICANT PUBLIC INTEREST BENEFITS.

The switched access rate reductions contained in the modified CALLS proposal will provide both immediate and continuing public interest benefits arising from significantly reduced long distance charges, if the proposal is adopted. First and foremost, the proposal guarantees benefits flowing from switched access rate reductions of $2.1 billion that will take effect on July 1, 2000. In addition, by targeting the X-factor productivity adjustment on switched access rates, the proposal will reduce these rates by almost 50% within the five-year duration of the CALLS plan. Because AT&T and Sprint have committed to flow these savings through to consumers, the proposed switched access rate reductions will generate enormous public benefits.

Several parties have criticized two aspects of the CALLS methodology for achieving these access rate reductions. First, some commenters assert that the plan calls for an arbitrary departure from existing price cap regulation.[58] In particular, they are concerned that the X-factor is targeted exclusively to the switching basket until switched access rate caps are reduced to target rates of 0.55 cents for the Bell Companies and GTE and 0.65 cents for most other price cap ILECs.[59] They argue that

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[58] *See* ALTS/Time Warner Comments at 8-12; Comments of Focal Communications Corporation, at 5-14 ("Focal Comments").

[59] The Coalition has agreed to a slightly higher rate for certain very rural price cap carriers. *See* Valor/CALLS Joint *Ex Parte* letter to Larry Strickling, Chief Common

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such targeting is inconsistent with the existing price cap regulatory regime and Commission precedent.[60] Second, several parties assert that the rate reductions for switched access are too steep and will thus inhibit entry of CLECs into the local exchange access market.[61] For the reasons stated below, none of these concerns has any merit.

A. The CALLS Methodology for Achieving Switched Access Reductions by Targeting the X-Factor's Effect on Average Switched Access Rates Is Reasonable and Consistent with the Commission's Stated Objective.

The CALLS methodology is fully consistent with the Commission's stated objective of "opening all telecommunications markets to competition."[62] To that end, the Commission has committed to "accelerat[ing] the development of competition"[63] in the local exchange market and facilitating "the removal of service from price cap regulation as competition develops in the marketplace."[64] It has repeatedly acknowledged that price cap regulation is not a permanent edifice; instead, "price caps act as a transitional regulatory scheme until the advent of actual competition makes

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Carrier Bureau (filed April 14, 2000).

60 *See* ALTS/Time Warner Comments at 8-10; Focal Comments at 5-7, 10-14.

61 *See* ALTS/Time Warner Comments at 2-3, 10.

62 *Access Reform Order* at 16094.

63 *Pricing Flexibility Order* at 14224.

64 *Id.* at 14225.

price cap regulation unnecessary."[65] Price caps thus merely represent the pricing methodology chosen by the Commission to replace traditional rate of return regulation and commence the transition toward an unregulated, competitive market for access services.[66]

Consistent with this stated objective, the CALLS plan represents an important additional step towards full competition in the local exchange market. It replaces the existing price cap methodology with one that significantly accelerates the decline in traffic-sensitive switched access and transport rates. Although the plan retains most of the attributes of the existing price cap regulatory regime, it departs from the existing price cap methodology in several important respects. A primary distinction is that participating[67] price cap ILECs will target all price cap reductions arising from the 6.5% X-factor to reduce the Average Traffic Sensitive rate, which comprises traffic-sensitive local switching and transport components, until the Average Traffic Sensitive rate cap reaches a prescribed target level.[68] By promptly reducing switched access rates from the present levels the CALLS plan will substantially achieve the Commission's goal of

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65 *Access Reform Order* at 15994.

66 *See Pricing Flexibility Order* at 14227.

67 The CALLS proposal is purely voluntary. In the event that the Commission adopts the proposal, ILECs that are not presently signatories to the plan may elect to take advantage of the benefits of the proposal by becoming signatories at any time prior to implementation. *See* Modified Universal Service and Access Reform Proposal, at § 6 (filed Mar. 8, 2000).

68 Further, once the Average Traffic Sensitive rate reaches the prescribed target rate, the X-factor is set at the rate of inflation for the remainder of the five-year term of the plan. *See id*. § 3.2.1.

reducing switched access rates to cost-based, competitive levels,[69] and it will do so quicker than would be possible under the existing price cap methodology.[70]

The modified CALLS plan also furthers the Commission's objective of obtaining a more appropriate allocation between flat-rate and MOU pricing of access services. In the *Access Reform Order*, the Commission emphasized that the "NTS [non-traffic-sensitive] costs should be recovered through flat fees, while traffic-sensitive costs should be recovered through usage-based [i.e., MOU] rates."[71] It acknowledged that "[t]he present structure violates this basic principle of cost causation by requiring incumbent LECs to recover many fixed costs through variable, per-minute access rates."[72] The *Access Reform Order* rectified a number of these "distortions" in the price cap regime by requiring ILECs to recover non-traffic sensitive ("NTS") costs through NTS pricing components, thereby reducing traffic-sensitive access rates.[73] Nevertheless, numerous distortions remain in the price cap regime, even as modified by the *Access Reform Order*.[74] The modified CALLS plan furthers the Commission's

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69 *See Access Reform Order* at 15995, 15998.

70 ALTS and Time Warner argue that it is "simply too early" to depart from the existing price cap regime "to drive down access charge prices." ALTS/Time Warner Comments at 8. They agree, however, as discussed in the text below, that the CALLS target rate caps provide the most appropriate end result for price cap regulation. Their objection is that the correct outcome is reached too quickly. This is an argument based on self-interest, not economic principle.

71 *See Access Reform Order* at 15998.

72 *Id.*

73 *See id.* at 16004-07.

74 *See Pricing Flexibility Order* at 14326-33 (seeking comments on replacing

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continuing efforts to realign the allocation of access rates between flat-rate and traffic-sensitive components by further reducing the proportion of access fees that ILECs recover from traffic-sensitive Average Traffic Sensitive rates and by increasing the proportion that they recover from flat-rate common line charges.

The CALLS plan would achieve dramatic reductions in switched access rates by initially targeting all X-factor adjustments to the Average Traffic Sensitive switched access and transport components. This proposal is entirely consistent with Commission precedent in the *Access Reform Order*, which adopted a similar strategy to accelerate the elimination of the traffic-sensitive tandem interconnection charge ("TIC"). In that *Order*, the Commission directed ILECs to "target to the TIC price cap *reductions arising in any price cap basket* as a result of the applications of the 'GDP-PI minus X-factor' formula."[75] The CALLS plan applies this same strategy to reduce switched access rates rapidly to more competitive levels.

ALTS/Time Warner and Focal Communications assert that there is no economic justification to depart from the present system of applying the X-factor equally to all price cap baskets.[76] This objection, however, is the same objection raised by ALTS in the recent *Access Reform* proceeding. The Commission expressly rejected this argument, noting in essence that the end to be achieved – "eliminat[ing] the

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existing MOU pricing of local switching and transport with capacity-based pricing).

75 *Access Reform Order* at 16081 (emphasis added).

76 *See* ALTS/Time Warner Comments at 8-10; Focal Comments at 8-9.

anticompetitive aspects of the TIC"[77] – justified the means, i.e., not applying any productivity adjustment to price caps until the TIC was eliminated, even if economic data supported widespread application of the X-factor to all baskets.[78] In any case, the economic data here shows that switched access rates contain significant implicit supports, and therefore targeting all X-factor adjustments to these rates will effectively promote universal service and efficient competition. Thus, the CALLS approach is not based on any conclusion as to the relative level of productivity gains in different baskets. Rather, it is based on the need to address the relative rate distortions in the price cap plan caused by decades of earlier policies.

For the same reasons, the FCC should reject ALTS/Time Warner's argument here.[79] As the *Access Reform* precedent demonstrates, it is entirely reasonable to

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[77] *Access Reform Order* at 16082.

[78] The Commission further noted that its targeting proposal was unobjectionable because TIC revenues would be spread evenly across all price cap baskets and service categories so that the reallocation would not insulate the TIC revenues against "the pressures of the competitive marketplace." *Id.* at 16082. The CALLS plan follows this same approach by applying the same (zero) productivity adjustment to all non-Average Traffic Sensitive rates.

[79] Focal's attempt to distinguish the application of a targeted X-factor to eliminate the TIC from the CALLS proposal to target the X-factor to significantly reduce the traffic-sensitive switched access rates is unavailing. Of course, two applications of the same methodology to different factual circumstances can always be distinguished at some level if one looks hard enough. The point is, however, that the two situations have sufficient common traits to justify the targeting of the X-factor proposed under the CALLS plan. For example, in both situations, the primary objective of the targeting is to further the Commission's objective of fostering competition by eliminating or reducing charges that are not set at competitive levels.

As Focal notes, the elimination of the TIC was necessary "to remove an otherwise objectionable non-cost-based charge that thwarted the development of competition in the interstate access market." Focal Comments at 11-12. The same is

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accelerate price cap reductions for a specific service category or subcategory where the goal is to obtain a reasonable, pro-competitive end result. In this case, ALTS/Time Warner have acknowledged that the CALLS target rate caps are an appropriate end result by adopting these same targets in their own proposal.[80] Accordingly, the CALLS plan's targeting of the X-factor to the Average Traffic Sensitive rate cap in order to more rapidly attain cost-based switched access rates is both reasonable and consistent with Commission precedent.[81]

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also true of switched access rates. Focal's suggestion that IXCs have not found the present access rate levels to be objectionable is disingenuous. *See, e.g.*, AT&T Ex Parte Letter, CC Docket No. 96-262, Attachment at unnumbered p. 9 (filed Feb. 25, 1999) (presenting data to support AT&T's argument that switched access rates were at levels substantially above economic cost). Because the CALLS plan seeks to use the targeted X-factor to significantly reduce switched access rates, this aspect of the CALLS proposal furthers the same pro-competitive goal as the Commission's provision of the *Access Reform Order* which directed ILECs to target the TIC.

[80] *See* ALTS/Time Warner Comments at 18 and attached Exhibit.

[81] ALTS/Time Warner's further argument that the CALLS proposal would deny consumers the benefit of productivity gains in the local loop while the X-factor is targeted on the Average Traffic Sensitive rate also lacks merit. First, because the Commission is dealing here with price *caps*, not prescribed *rates*, there is nothing to prevent local loop prices from falling below the price cap levels. Second, this argument is unavailing for the same reason it was unavailing in the *Access Reform* proceeding – the pro-competitive benefits resulting from the accelerated reduction of one price cap outweigh any "harm" imposed by temporarily deferring reductions to other price caps.

The Ad Hoc Telecommunications Users Committee ("Ad Hoc") raises a related concern: it asserts that the CALLS proposal provision which precludes ILECs from applying "exogenous cost" increases to Average Traffic Sensitive rate elements will shift recovery of these costs to NTS components such as special access. *See* Comments of Ad Hoc, at 7-8. Although this statement is correct, it is the natural and beneficial consequence of targeting revenue reductions to the traffic-sensitive switched access service categories (which enables the rapid attainment of competitive Average Traffic Sensitive rates). In any event, the Commission has authority to review exogenous cost claims and require reallocation of exogenous costs if it deems

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Remarkably, ALTS/Time Warner's opposition to targeting of the X-factor is totally inconsistent with their alternative proposal, which also targets the X-factor to specific access baskets and service categories, albeit different ones than CALLS proposes. Under the first phase of the ALTS/Time Warner proposal, revenue reductions flowing from application of the existing 6.5% X-factor would initially be targeted as follows: (1) 50% of the reductions would be targeted to eliminate the carrier common line charge ("CCLC") and the multi-line business PICC ("MLB PICC"); and (2) the other 50% of the revenue reductions would be directed to reducing Average Traffic Sensitive rates.[82] This aspect of the ALTS/Time Warner proposal clearly requires the X-factor reductions to be targeted (though in a less focused and more complicated manner than the CALLS proposal). Further, under the second phase of their proposal, once the CCLC and the MLB PICC have been eliminated, all X-factor revenue reductions would be targeted at the Average Traffic Sensitive elements, as under the CALLS proposal.[83] Accordingly, although the ALTS/Time Warner proposal differs from the CALLS plan, it employs *exactly the same* methodology – targeting of the X-factor to specific service categories – to achieve its goals. ALTS/Time Warner's objection to the use of X-factor targeting in the modified CALLS proposal thus rings hollow. Rather than being grounded in any principled objection to the CALLS methodology, ALTS/Time Warner's objection should be seen for what it really is: mere

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necessary.

82 *See* ALTS/Time Warner Comments at 4, 15-16.

83 *See id.* at 4, 17-18.

disagreement with *how* the X-factor should be targeted (CALLS advocates that all rate reductions should be directed to traffic-sensitive access categories, whereas ALTS/Time Warner asserts that selected flat-rate service categories should receive equal priority).[84]

Nor does the CALLS proposal's targeting of X-factor reductions to Average Traffic Sensitive rates constitute "premature pricing flexibility" as Focal asserts.[85] Rather than granting ILECs unlimited flexibility to allocate the X-factor revenue reductions among the traffic-sensitive local switching and transport service categories, as Focal suggests, the CALLS proposal instead requires ILECs to continue to comply with pricing flexibility constraints that currently exist under the price cap regime. Nothing in the modified CALLS proposal alters the existing band limitations on ILEC pricing flexibility contained in Section 61.47(e), which have existed in some form since price caps were introduced in 1990.[86] Thus, far from granting ILECs premature pricing flexibility, the CALLS proposal retains the existing limitations on pricing flexibility contained in Section 61.47(e).[87]

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[84] GTE disagrees that any of the access rate reductions should be targeted to flat-rate common line basket service categories.

[85] *See* Focal Comments at 14.

[86] *See LEC Price Cap Order* at 6810-11; In a subsequent Order, the Commission removed the lower pricing bands. *See Access Charge Reform*, 11 FCC Rcd 21354, 21487-88 (1996) (Notice of Proposed Rulemaking, Third Report and Order, and Notice of Inquiry).

[87] Moreover, because the CALLS proposal does not modify the existing pricing flexibility rules, there is no restriction on the allocation of Average Traffic Sensitive rate reductions among its constituent service categories, which include traffic-sensitive tandem switching and tandem transport. With regard to the modified CALLS plan's

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Focal asserts that the CALLS plan's targeting of the X-factor to the Average Traffic Sensitive rate results in the creation of "an arbitrary selection of X Factors scattered throughout the price cap scheme."[88] This assertion is unsupportable.[89] With only one minor exception for special access services in the first year of the plan, the modified CALLS proposal requires the application of only one X-factor.[90] Until switched access rate caps are reduced to the target levels, the proposal retains the existing 6.5% X-factor. Once the target levels are attained, the X-factor becomes equal to GDP-PI to offset any upward inflation adjustment to price cap levels.[91] The proposal is simple, straightforward, and, contrary to Focal's assertion, does not establish a multitude of X-factors.[92]

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proposed one-time rate reductions on July 1, 2000, the plan guarantees that local switching will receive a proportionate share of the decrease. *See* Modified CALLS Proposal § 3.2.4. Other rates will be reduced in accordance with the existing price cap rules.

88 Focal Comments at 12.

89 Notably, Focal fails to provide citations to *any* examples of the alleged wide "selection" of X-factors that it contends exist in the CALLS proposal.

90 *See* Modified CALLS Proposal § 3.2.1. The exception provides for the application of a 3.0% X-factor to special access services in 2000. *See id*. § 3.2.7.

91 *See id*. § 3.2.1.

92 The *Access Reform Order* is again also dispositive of Focal's argument. The *Order* does not reflect any contention by any party that the targeting of the TIC would result in a multitude of X-factors. *See Access Reform Order* at 16081-86. Nor did the Commission interpret the targeting mechanism as creating multiple X-factors. *See id*. In describing the *Access Reform Order*'s targeting of the TIC, Focal states:

> [T]he targeting of the X Factor to the TIC did not involve an arbitrary selection of X Factors scattered throughout the price cap scheme.

(Continued...)

Focal also challenges the reduction of the X-factor to GDP-PI, once the target Average Traffic Sensitive rate is reached, as arbitrary.[93] On the contrary, the CALLS proposal to reduce the X-factor to the rate of inflation once switched access rates have been dramatically reduced is justified by expected productivity increases that would be possible at these lower rate levels. As GTE explained in its Reply Brief to the initial CALLS proposal, there are numerous reasons why the X-factor would need to be reduced. First, productivity gains are rapidly declining, due in part to a decline in switched access minute growth over the past decade.[94] Second, at lower access rate levels, further significant productivity gains become increasingly difficult to achieve.[95] Notably, even Focal stops short of asserting that productivity advances will even approximate 6.5% over the next five years. Third, even with the application of a reduced X-factor for the remainder of the five-year plan, switched access price caps will be at lower levels than would be achieved if the existing 6.5% X-factor is applied to existing rates over the five-year period covered by the CALLS plan. Finally, because

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(...Continued)
Instead, other baskets and charges governed by price caps receive no X Factor reductions until the TIC is eliminated. Thus, targeting of the X Factor to the TIC merely defers X Factor reductions for other rate elements and baskets until the TIC is phased out, and, therefore, does not involve application of different X Factor reductions to different price cap baskets.

Focal Comments at 12. This analysis applies equally to the CALLS plan's targeting of the Average Traffic Sensitive rate until target rates are achieved.

93 *See* Focal Comments at 9-10.

94 *See* Reply Comments of GTE, at 40-41 (filed Dec. 3, 1999).

95 *See id.* at 39.

the price caps represent price ceilings, not prescribed switched access rates or, as some continue to claim, price floors, there is nothing to prevent market conditions from driving down rates faster than the X-factor rate.[96]

Moreover, the adoption of GDP-PI as the X-factor once the target price caps are reached is entirely reasonable.[97] It will enable price caps to be frozen at the target levels, thus ensuring consumers that switched access rates will continue to decline in real terms. It will also continue to require ILECs to achieve productivity gains. Indeed, because of the impact of rising input costs, carriers will continue to be forced to achieve productivity gains to remain profitable, which is consistent with the existing price cap incentive scheme.[98] Further, the CALLS proposal to reduce the X-factor to GDP-PI once target switched access rate caps are achieved has garnered the support of the largest CLEC trade association, ALTS. The ALTS/Time Warner proposal mirrors the CALLS proposal by advocating the reduction of the X-factor to the level of inflation once the target switched access rates are achieved.[99]

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96 *See id*. at 42-43.

97 Focal's assertion that the CALLS plan may entail a "startling proposal to eliminate" the X-factor, Focal Comments at 9, is patently false.

98 Furthermore, the GDP-PI-based X-factor will be applied evenly to all price cap baskets, as under the current price cap scheme.

99 *See* ALTS/Time Warner Comments at 18. Moreover, ALTS/Time Warner also argue for adoption of the *same* target rate caps that are contained in the modified CALLS proposal. *See id*. at 4, 18 & Exhibit.

B. CLECs' Belated Attempts to Argue that the Glide Path to the Target Switched Access Rates Is Too Fast Should Be Rejected.

ALTS/Time Warner argue that the glide path to the target Average Traffic Sensitive rates set out in the CALLS proposal is too steep. By targeting the entire X-factor adjustment to the Average Traffic Sensitive rate element, CALLS predicts that the target rates will be achieved within the five-year term of the plan.[100] ALTS/Time Warner contend that, because switched access rates are a major source of CLEC revenue, dramatic reductions in these rates will competitively disadvantage CLECs, thereby raising their investment risk and cost of capital; the increased cost of capital in turn, they argue, reduces the ability of companies to enter the local exchange market as facilities-based competitors to ILECs.[101]

At the outset, it must be noted that none of the commenters argue that the target rates proposed in the modified CALLS proposal are too low.[102] Although a declaration submitted with Focal's comments includes a discussion of the issue of predatory pricing, neither the declaration nor Focal's comments allege that the CALLS plan would establish predatory pricing levels.[103] Indeed, the commenters that expressly object to the level of the target caps in the CALLS proposal argue that the rates are too *high*.[104]

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100 *See* Memorandum in Support of the Coalition for Affordable Local and Long Distance Service Plan, CC Docket No. 96-262 et al., at 37 (filed Aug. 20, 1999).

101 *See* ALTS/Time Warner Comments at 10.

102 The Rural Independent Competitive Alliance ("RICA") contends that the proposed reductions in ILEC switched access rates will exacerbate the amount of charges that are disputed by IXCs. *See* RICA Comments at 5. It does not assert, however, that the target rates are too low.

103 *See* Focal Comments at 8; Declaration of Jeffrey I. Bernstein, Apr. 3, 2000 ("Bernstein Declaration") at 1-2. The Bernstein Declaration states that the cost

(Continued...)

Rather than objecting to the target rate levels,[105] ALTS/Time Warner contend that the dramatic rate reductions occur too rapidly, thus warranting rejection of the modified CALLS proposal. This argument lacks merit for several reasons. First, given that they consider the CALLS plan's proposed target rate caps as an appropriate end result of price cap regulation, their argument simply makes no economic sense. A more gradual glide path to the CALLS target rate caps would merely mandate higher rates, and thus, provide CLECs with higher revenues for a transitory period. If this is correct, as ALTS/Time Warner suggests, this artificial revenue boost would encourage additional CLEC entry into the local exchange market resulting in investment that would be misguided and economically unsound in the long term. In other words, a slower decline in switched access price caps would partially mask the risk arising from future lower access prices and would thus encourage too much CLEC investment, i.e., investment by CLECs that will be unable to compete with ILECs once access prices approach cost-based levels.

(...Continued)
information necessary to assess predatory pricing is not available. Bernstein Declaration at 2.

[104] *See* Comments of Level 3 Communications, LLC, at 7; Comments on Behalf of the New Jersey Division of the Ratepayer Advocate on the CALLS' Modified Proposal, at 3 (reiterating its earlier (mistaken) comments that the target rate caps preclude ILECs from reducing switched access rates to cost-based levels).

[105] ALTS/Time Warner have submitted an alternative proposal which adopts the same target rate caps contained in the modified CALLS proposal. *See* ALTS/Time Warner Comments at 18 and attached Exhibit. Presumably, ALTS/Time Warner would not propose target rates that they believe have no economic foundation.

Second, ALTS/Time Warner's argument, stripped of its fig leaf of an economic justification, is that the Commission should allow CLECs to maintain their existing practice of "umbrella pricing," i.e., pricing access services just below the rates offered by ILECs.[106] Although this practice is widespread among CLECs, economists recognize that it is harmful to competition.[107] The CLECs' opposition to rapid access price reductions implicitly seeks to preserve this detrimental pricing strategy for their self-interest, and should thus be rejected.

VI. THE COMMISSION SHOULD EITHER REJECT OF DEFER TO OTHER PROCEEDINGS A MYRIAD OF PAROCHIAL REQUESTS RAISED BY COMMENTERS.

A number of parties, some of whom have not participated in earlier rounds, have used the opportunity for filing comments to throw rocks at those walking down the path seeking a solution to access, price cap and universal service issues. These parties are attempting to convince the FCC to adopt their pet issues under the guise of "challenging" the CALLS proposal. The FCC should refuse to address these side issues here.

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106 A common related CLEC practice is targeting entry primarily (or exclusively) into low-cost, urban areas. This business strategy takes advantage of the inefficiencies of the existing price cap regime. Because price caps in these areas are substantially above cost, CLECs are able to cream-skim by slightly undercutting the access prices of ILECs in these areas. By bringing switched access rates closer to cost-based levels and by permitting SLC deaveraging, the modified CALLS proposal removes many of the incentives for CLECs to cream-skim.

107 *See Tyson Study* at 9.

Although the CALLS proposal is a comprehensive solution to a large number of intractable problems that have been plaguing the Commission and industry for years, it does not purport to resolve every single issue that has arisen or will arise in the telecommunications area. GTE urges the Commission to focus on the proposal and the solutions it offers and to move forward to adopt the proposal without considering these other issues right now. These issues can be considered, if warranted, in an orderly fashion in other proceedings.

A. Payphone Issues Are Pending in Other Proceedings and Should Be Resolved There.

Payphone operators and operator service providers urge the Commission to address a number of issues related to the application of SLCs to private payphones and to presubscribed carriers at payphones. American Public Communications Council, for instance, argues for the first time in this proceeding that the SLC should not be applied to payphones at all.[108] One payphone provider argues that the PICC is discriminatorily applied to independent payphone providers.[109] Finally, One Call repeats its arguments made in an earlier comment round that payphones should pay the single-line business SLC, not the multi-line business SLC.[110]

Regardless of the merits of these arguments, the Commission has been addressing payphone-related issues in a variety of rulemaking and complaint

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108 Comments of the American Public Communications Council, at 5-7.

109 *See* Comments of One Call Communications, Inc./Opticom, at 6.

110 *Id.* at 11-13.

proceedings.[111] These parties have not demonstrated that there is a critical need to address these issues here, or that a resolution of the issues would somehow affect or undermine the way in which the main provisions of CALLS proposal are implemented. Therefore, the Commission should refuse to address these issues here.

B. The Level of CLEC Access Charges Is Beyond the Scope of This Proceeding.

Allegiance, for the first time in this proceeding, asks the Commission to address the level of CLEC access charges.[112] It seeks such a resolution in order to force AT&T and Sprint to pay their access bills from certain CLECs.[113] The FCC should refuse to decide this issue here because it is already under consideration in another rulemaking.[114] More importantly, the CALLS proceeding is intended to focus on how to reform interstate access for price cap carriers. CLEC access services are treated as nondominant and, therefore, are not actively regulated by the Commission at this

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111 *See, e.g.*, *CF Communications Corp., et al. v. Century Telephone of Wisconsin, Inc., et al.*, File No. E-89-170 et al., (Apr. 13, 2000); *Implementation of the Pay Telephone Reclassification and Compensation Provisions of the Telecommunications Act of 1996*, 11 FCC Rcd 20541 (1996). For the record, GTE's refusal to answer these arguments here should not be interpreted to mean that it agrees with these parties comments.

112 *See* Allegiance Comments at 4 (submitting a "public offer" that CLEC access rates be capped at NECA levels).

113 *See* Allegiance Comments at 2 & n.2. RICA also expresses concern about this issue, but does not offer a specific solution. *See* RICA Comments at 3-5.

114 *See Pricing Flexibility Order* at 14338-49.

time.[115] As such, CLEC access issues are irrelevant to the CALLS solution and should not be addressed here.

C. The FCC Should Not Consider Arguments About Changing the Exogenous Cost Rules.

Ad Hoc suggests that the Commission modify the current rule that dictates how exogenous costs are to be treated within the price cap formula. It argues that ILECs should not be permitted to seek price cap adjustments based on exogenous costs for legal or regulatory changes that the ILECs themselves have supported.[116]

The FCC should refuse to consider this rule change. Exogenous cost treatment is governed by Section 61.45(d) of the Commission's Rules. The Commission has described exogenous cost treatment as one that deals only using "extraordinary" costs, which is an exception to the general rule that price caps are not adjusted for changes in ILEC costs.[117] For this reason, the Commission considers each request on a case-by-case basis. Although Ad Hoc's argument may have a certain emotional appeal for parties that disagree with ILEC policy positions, there is absolutely no reasoned basis for a blanket rule that exogenous cost treatment is not justified simply because the legal change was supported by an ILEC. GTE submits that any such argument can be made at the time exogenous cost treatment is sought and, if the particular change is not justifiable under the current rules, the Commission should reject it on its own merits

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115 *See, e.g.*, *Access Reform Order* at 16140-41.

116 Ad Hoc Comments at 7.

117 *Price Cap Performance Review for Local Exchange Carriers*, 12 FCC Rcd 16642,16711-12 (1997); *LEC Price Cap Order* at 6810.

at that time. There is no justification, however, for adopting a blanket rule to prohibit exogenous cost treatment in this circumstance and it should be rejected.

D. It Would Be Counterproductive to Freeze All Proposed and Future Changes to the Pricing Flexibility, Depreciation, Accounting, and Affiliated Transaction Rules.

MCI WorldCom argues that the Commission should suspend its pricing flexibility rules to prevent anticompetitive effects from the Commission's decision temporarily not to allow the use of unbundled loop and transport combinations as a substitute for special access.[118] It also urges the Commission to refuse to make any further depreciation, accounting and affiliated transactions rule changes during the CALLS implementation period.[119]

The FCC should reject these requests. Even though the CALLS plan is comprehensive, there are strong public policy arguments that require the Commission's pricing flexibility rules to remain in place.[120] In fact, the CALLS plan does not even address these flexibility rules. The market is changing rapidly and competition is growing. Although hobbling one set of competitors will help an individual competitor like MCI WorldCom, it would produce disastrous results for customers who will be denied the benefits of full and vigorous competition. Furthermore, there are continuing needs for accounting and depreciation reform even after CALLS is adopted.[121] The

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118 Comments of MCI WorldCom, Inc., at 17-21.

119 *Id.* at 26.

120 *See, e.g.*, *Pricing Flexibility Order* at 14232-33, 14257.

121 The FCC recently adopted an order on depreciation, on which they have recently sought further comment. *See 1998 Biennial Regulatory Review, Review of*

(Continued...)

Commission should not hesitate to make real strides in accounting reform that will help to create a competitive market structure. With such efforts the Commission can ensure that, at the end of the CALLS transition, there will be no further need for intrusive regulation.

VII. CONCLUSION.

It cannot be stressed enough that the CALLS proposal represents the Commission's best road map out of the regulatory thicket of three of the largest issues facing it today: universal service, subscriber line charges and access rates. The Commission has been working tirelessly for years to achieve resolution to these issues, yet each time it took a step the Commission only found itself stuck in a morass of legal, procedural, and policy issues. Today, those parties that have long been at loggerheads have worked together to draw up a plan that will help move the industry out of the thicket and onto the clear road leading to the open fields of competition.

Those parties throwing rocks at this effort have missed the target. The procedure used is right and reasonable; attempts to derail the process by introducing side issues must be rebuffed. The public interest benefits to the CALLS plan are real, the plan will help consumers, and the holistic approach will bring competition to all sectors of the country. GTE strongly urges the Commission to take the right first step and adopt the CALLS plan as proposed.

(...Continued)
Depreciation Requirements for Incumbent Local Exchange Carriers, FCC 99-397 (Dec. 30, 1999); *see also Comprehensive Review of the Accounting Requirements and ARMIS Reporting Requirements for Incumbent Local Exchange Carriers: Phase 1*, FCC 00-78 (Mar. 8, 2000).

Respectfully submitted,

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April 17, 2000

Comments on the Proposal by the Coalition for Affordable Local and Long Distance Service

Dr. Laura Tyson

April 17, 2000

TABLE OF CONTENTS

I. OVERVIEW AND PURPOSE

The Coalition for Affordable Local and Long Distance Service (CALLS) plan describes a process for access charge reform that will establish explicit subsidies to replace a portion of implicit subsidies included in current access prices. The purpose of my comments is to: 1) place this plan within the framework of economic principles; and 2) explain why it is a positive step toward a regulatory environment that promotes the development of efficient competition in telecommunications and furthers the development of a quality infrastructure that benefits all consumers.

Subsidies are necessary for maintaining support for universal service, but, in the emerging competitive environment, the current method of collecting this money through implicit subsidies is unsustainable and inefficient. In a regulated monopoly environment, implicit subsidies in the form of prices held well above costs for selected services were sustainable and provided funds for investments that resulted in the most extensive telephone network in the world. In a competitive environment, entrants can price under the incumbents' pricing umbrellas and siphon off the "tax" revenue that was previously used by incumbents to fund universal service. The loss of the tax revenues is removing funds necessary to continue the high level of investment in the infrastructure, especially in rural areas.

In Section II, I provide a brief discussion of the legacy of implicit subsidies in telecommunications. This provides a framework for discussing the changes in the current pricing structure that are required to develop efficient competition. In Section III, I describe economic goals that guide the transition from implicit to explicit subsidies. In Section IV, I discuss changes in the nature of communications demand and supply that have increased the value and affordability of access to telecommunications networks. In Section V, I summarize the components of the CALLS plan and view this plan in light of the economic goals described in Section III and the overall affordability of access to telecommunications networks discussed in Section IV. In Section VI, I offer concluding remarks.

II. THE LEGACY OF IMPLICIT SUBSIDIES

Implicit subsidies in telecommunications prices are the legacy of decades of regulation, the split up of the Bell System in the mid-eighties, and the inherent characteristics of telecommunications demand. Funding the long-standing goal of universal service provided the motivation for regulators to create many of the implicit subsidies that persist in telecommunications today. In a regulated monopoly environment, implicit subsidies were sustainable, and any inefficiencies from non-cost-based pricing were deemed worth the price. After divestiture in 1984, cracks in the sustainability of subsidies began to show with the emergence of bypass alternatives. One subsidy created at divestiture is above cost access prices that local phone companies charged interLATA service providers to connect to the local networks. Not long after divestiture, competitive access providers (CAPs) surfaced. These

companies aggregate interLATA traffic for large business carriers and deliver it to the long distance companies at a price closer to cost, thereby reducing funds that were designed to subsidize universal service. The concentration of demand in low cost, high revenue areas helps make this a successful strategy. The combination of implicit subsidies collected from access and other services and the high concentration of telecommunications demand are also directing the entry strategies of today's competitive local exchange carriers (CLECs). With numerous entrants actively pursuing profit opportunities, the incumbent local telecommunications companies are no longer able to collect charges that operate like "taxes" (revenues far in excess of costs) required to subsidize residential service and investments in rural areas.

A. Local Telephone Pricing and Rate Regulation Prior to Divestiture

By the 1920s in much of the nation, a variety of political and economic forces led to the consolidation of competing local telephone networks into monopolies. As consolidation occurred, regulation increased. By 1921, regulators in 44 states, typically public utilities commissions, were granted authority to regulate local telephone companies. Rate of return was the predominant form of regulation over prices in telecommunications.[1] Overall, rates of return were based on cost considerations, including the cost of capital. For specific services, however, prices were often set with an eye toward public policy goals. To derive funds to support affordable, below cost, residential service in rural areas, prices for urban and business customers were held above cost. This is often called value of service pricing. Another source of funds to support universal service is the jurisdictional separation of costs between interstate and intrastate services. In time, this separation process resulted in artificially high amounts of costs allocated to interstate services, which led to subsidy laden prices charged to interstate service providers for access to local networks and the current need for access charge reform.[2]

1. Rate of Return Regulation

The purpose of traditional rate of return regulation was to balance the interests of privately owned utilities with those of captive ratepayers. Regulation allowed companies to generate enough revenue to cover reasonable costs, earn returns on shareholder investments, maintain their credit ratings and invest in new facilities. Rate of return regulation also prevented companies with market power from earning excessive profits or discriminating against certain classes of consumers.[3]

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[1] Jeffrey E. Cohen, "The Telephone Problem and the Road to Telephone Regulation in the United States, 1817- 1917," *Journal of Policy History*, 1991, pp. 42-69.

[2] The amount of subsidy remaining in interstate and intrastate access prices differs significantly by state.

[3] Charles F Phillips, Jr., *The Regulation of Public Utilities*, Public Utilities Reports Inc., 1988, p. 164, 168.

During rate cases, regulators closely scrutinized companies' financial books to determine the legitimate costs of doing business. These costs, which included a reasonable return on net capital investments, depreciation, and operating costs, were known collectively as the revenue requirement. Prices were set so that companies would generate enough revenue to cover the requirement, and any "over-earning" was subsequently returned to ratepayers through a rebate or price reduction. As part of rate regulation, many states required franchise monopoly local telephone companies to serve all customers in the franchise areas at geographically averaged prices through the imposition of carrier-of-last-resort obligations.[4]

2. Rate Design and Value of Service Pricing by Customer Class

The early approaches to local price design were based on the concept of "value of service" pricing. This approach set prices for different groups of customers (e.g., business versus residential, and urban versus rural) based on the values of the services to the customer groups and not on the underlying costs of providing service. It is common for business customers to pay more for local service than residential customers, even when the cost of providing service is similar. It is also common for urban customers to pay the same or more than rural customers, even though the per customer cost to serve urban areas is typically much less than the cost to serve rural areas. For example, the prices for basic business and residential lines in Atlanta, Georgia are $48.30 and $17.45 respectively, and the price of a residential line in the rural town of Lumpkin, Georgia is $12.50. While there were economic inefficiencies inherent in this type of pricing structure, it was sustainable in a monopoly environment. These prices, which persist in many geographic areas, are not sustainable in a competitive market. They are also inconsistent with the development of beneficial and efficient competition and the continued development of a strong telecommunications infrastructure.

3. Separations and Cost Allocation Between State and Federal Jurisdictions

Setting prices for, and allocating costs between, long distance and local services posed similar problems to setting prices for different classes of local customers. Because the Bell System was a multi-product firm, offering local and long distance services, regulators needed to apportion the costs of the network among different services. The process of separating costs and expenses between the interstate jurisdiction (regulated by the FCC after 1934) and state jurisdictions (regulated by public utility commissions) became known as the jurisdictional "separations" process. In effect, separations allocated a portion of the cost of the local telephone network, including the loop, to long distance services. Today, it is widely recognized by economists and policy-makers that this allocation system is inefficient because the cost of the loop

[4] More recently, many state regulators and the FCC implemented incentive-based price regulations such as price cap plans. Price caps typically require regulated companies to reduce prices steadily based on some measurement of average industry productivity growth. If, however, companies can reduce costs more quickly, then they are allowed to retain at least a portion of the additional profits generated from above average reductions.

is caused by the provision of local telephone service. The use of the loop is not usage sensitive, and its cost should, therefore, be recovered through flat-rate charges paid by the end users to promote the efficient use of the network.[5] In summary, *long distance* charges subsidized *local* service.

B. Divestiture, Access Charges and Cross Subsidies

When the Bell System was dismantled in 1984 as part of the divestiture process under the Modification of Final Judgement consent decree, the cross-subsidies formerly embedded directly in AT&T's long distance rates were moved to the access charges received by local telephone companies for connecting long distance calls. These access charges were intentionally set at rates that were above the costs of providing the service.

1. Access Charges, Cross-Subsidies, Local Prices and Revenue Short Falls

Access charges contain substantial subsidies, developed over many years in a regulated environment. As noted by the FCC, "[r]ecovering on a per-minute basis the cost of the local loop, which is a fixed cost that does not vary with use, results in high-volume toll users paying charges to their IXCs [interexchange carriers] that exceed the cost of serving those customers, while some low-volume toll users may pay rates that are below cost."[6] Cross-subsidies from access services to local service are part of a wider pattern of subsides designed to promote universal telephone subscription.

- business customers subsidize residential customers;
- high volume callers subsidize low volume callers;
- urban customers subsidize rural customers; and

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[5] The FCC explained that the Federal State Joint Board on Universal Service reform, comprised of state and federal regulators, agreed that the costs of the loop should not be recovered via traffic sensitive or per minute charges:

> "The Joint Board suggested that the Commission change the existing rate structure so that incumbent LECs are no longer required to recover any of the NTS cost of the local loop from IXCs on a per-minute basis. The Joint Board noted that it would be preferable for costs related to the loop to be recovered in a manner that is consistent with the manner in which the costs are incurred." See Notice of Proposed Rulemaking, *In the Matter of Access Charge Reform*, CC Docket No. 92-626, FCC 96-488, December 24, 1996, paragraph 59. (Hereafter "Access Charge Reform Notice of Proposed Rulemaking").

[6] Access Charge Reform Notice of Proposed Rulemaking, paragraph 43.

- customers who use vertical services, such as custom calling features, subsidize customers who do not use such features.

These subsidies are not windfalls to the incumbent local exchange companies. They are a means of "taxing" certain customer groups to support below cost service for other customer groups. Taxes are collected by incumbent LECS and other facilities-based providers and are used to: 1) pay for the cost of the local network, including basic local service for all households and small businesses at "affordable" prices; and 2) make continuous investments in the network to ensure high quality service and the deployment of advanced services to all customers. The overall impact of these subsidies is that many high cost, low usage customers today pay less for basic local service than it costs to provide this service.[7]

2. Implicit Subsidies are Not Conducive to Efficient Competition

In a regulated monopoly environment, the cross-subsidies described above were sustainable because competitors could not enter the market and cream skim the revenues or drive down prices. In this environment, overall revenues and costs were balanced and incumbent local exchange companies (ILECs) were able to fund universal service and earn an acceptable return on their investments. Even today, implicit subsidies remain important to the financial viability of the facilities-based providers of universal service because some rates remain below cost. In a competitive environment, however, implicit subsidies are not sustainable and are contrary to the development of efficient and beneficial competition. Competitors are circumventing these subsidies by building alternative networks in the high-density urban areas where there are high proportions of business customers. For example, AT&T now uses assets obtained with its purchase of TCG to offer local service. TCG has "local networks aimed at addressing high-volume business customers…TCG initially targets the large telecommunications-intensive businesses concentrated in the major metropolitan markets served by its networks. TCG also targets small- and medium-sized business customers in office buildings or multiple dwelling units already served by its network."[8] As competitors enter these markets where prices are held above cost, they skim the above cost revenues and eventually drive prices down. Money tagged for universal service support dwindles, and incumbents' abilities to continue to maintain and improve the infrastructure is reduced, especially in rural areas. Examples of cream skimming are pervasive in metropolitan areas throughout the nation.

C. Characteristics of Telecommunications Demand

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[7] For a discussion of implicit subsidies in the FCC's regulatory systems see FCC First Report and Order in the Matter of Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, Transport Rate Structure and Pricing, and End User Common Line Charges, CC Docket No. 96-262, Released May 16, 1997, paragraphs 28-31.

[8] AT&T, 1998 10K Report, "Other Businesses, Local Services."

An important aspect of the telecommunications environment that adds an urgency to the current situation is the high concentration of revenues in relatively small geographic areas. In many states, well over one-half of the local telecommunications revenues are in less than 20 percent of the high density wire centers. Cross-subsidies in incumbent LEC's prices (especially subsidies from urban to rural and business to residential customers) are one reason for these high concentrations of revenues. Prices are typically held high relative to costs for urban and business customers.

The regulatory and economic factors described above – the pricing structure for local telephone service which deviates from cost, the traditional methods for regulating incumbent local service providers, and the characteristics of telecommunications demand – set the backdrop for considering the task of reforming telecommunications policy and pricing in the post-Telecom Act period.

III. MOVING TOWARD PUBLIC POLICY FOR A COMPETITIVE ENVIRONMENT

Telecommunications policy in the United States has three long-standing, interrelated goals: 1) to provide universal service; 2) to ensure that telecommunications services are produced and consumed efficiently; and 3) to promote infrastructure investment and service innovation that benefits consumers. These policy goals are often mutually compatible (i.e., a pricing structure that promotes the efficient consumption of telecommunications services by end users will also typically promote the efficient use of inputs into the telecommunications service production process and promote innovation). The Telecommunications Act shifted the framework for pursuing these goals from one that was predominantly based on regulation to one that is based on competition and cross-entry among different classes of service providers.

Before these goals can be achieved by the competitive process, however, a number of legacy regulations and pricing mechanisms need to be reformed. The transfer of money from high volume long distance callers to low volume callers, for example, is inconsistent with the development of efficient competition. It is also unsustainable. The following sections explain how reforming the current price structure for access charges and basic local telephone service will promote the three goals of telecommunications policy listed above.

A. Efficiency Objectives and the Reform of Implicit Subsidies

The current access pricing structure impedes the development of efficient competition. To the extent that prices for long distance services reflect the money paid for access to local networks, above cost access prices will contribute to artificially higher prices for long distance usage. This, in turn, will reduce the amount of long distance usage below the economically efficient level. This type of pricing distortion leads to a reduction in *allocational efficiency* because consumers change the allocation of their consumption away from the optimal mix they would have chosen if prices were based on the costs of producing services.

Second, artificially high access charges create a price umbrella that allows new competitors to enter the access services market and win customers from the incumbent, even if they are less efficient producers of the service or charge prices that include a premium. For example, the entry of competitive access providers (CAPs) into urban areas in the late 1980s and early 1990s can be explained in large part by above cost switched access prices charged by incumbent LECs. It is far from clear that many CAPs produce access services more cost-effectively than the incumbents. They are able to beat the incumbent's prices because they are allowed to target their efforts at high revenue, low cost customers. Incumbent LECs are restricted by price averaging and the necessity of maintaining low cost basic residential service. When the suppliers of a service are not the most cost-effective producers, resources are used inefficiently. In this situation, *technical efficiency*, which relates to optimizing the use of inputs to provide a given output in the most cost-effective way, is not achieved.

B. Investment, Innovation and Dynamic Efficiency

A fundamental goal of telecommunications public policy is to promote investment in telecommunications infrastructure and the development of innovative new services and technologies. One of the chief benefits of a free-market economy is that competition stimulates the development, introduction and adoption of new technologies. The pricing of existing services clearly has a critical influence on investment in new technologies. Below cost prices for rural local telephone service today, reduces or eliminates the incentives for competitors to adopt better, lower cost technologies for providing rural service. For example, it will curtail investment by competitors in developing and installing fixed wireless local loop technology, even if the underlying network economics of wireless technology make it a cost effective way to deliver service to rural customers. Conversely, if prices are set based on actual costs and rural subsidies are available to wireless competitors that adopt the universal service obligations, *dynamic efficiency* – the optimal rate of investment in new technologies – is promoted.

The current access charge structure and the corresponding implicit subsidies for rural residential service also reduce the incentive and ability of incumbents to invest in rural networks. With increasing competition, subsidies from high volume urban customers are decreasing, and incumbents are losing the funds necessary for investing in rural networks. Cross-subsidies are incompatible with competition, because: 1) competitors with no carrier-of-last-resort obligations and price averaging requirements can exploit the prices of those who bear these obligations; and 2) states will no longer be able to use the franchise regulation as a tool to ensure a fair return on the investments of telecommunications service providers. Hence, competition requires the use of different tools to achieve public policy objectives.

Although the telecommunications industry is moving toward a more competitive environment, regulation remains a powerful force in this industry, as is evidenced by the fact that these issues are before the FCC and state regulatory commissions throughout the nation. In this transition period, regulatory uncertainty can provide a large impediment to efficient investment.

C. Universal Service and Distributional Equity Goals

Historically, there have been two distributional equity objectives in telephone regulation. The first equity objective is "universal service." To reach this objective, it is necessary that basic telecommunications service is affordable for all households that desire service. To achieve this objective in a regulated environment, regulators maintained the prices of residential services at low, geographically averaged levels that nearly everyone could afford and made lifeline support available for the remaining households. In many instances the price of residential service did not cover the full economic cost of providing this service.

There is nothing exceptional about subsidizing the price of goods or services to make them more affordable.[9] Typically, however, policy-makers fund social equity objectives with taxes and distribute the money directly. In the telephone industry, universal service is funded largely through internal cross-subsidies and distributed with investments and other costs in rural areas. With increasing technological alternatives to the incumbents' landline networks and the onset of competition, entrants can offer customers who are providing the subsidies a means of avoiding this "tax."

The second equity objective is to provide the opportunity for investors to earn a fair return for the use of their capital and the risk of investing in network infrastructure. Fair treatment of investors is based on a constitutional principle (the Fifth Amendment protection of property from taking without just compensation), and it is also good public policy. By creating a social contract between the shareholders of a telephone company and citizens of a state, future investment is encouraged. The typical social contract requires the provider to promise to serve all customers in a given geographic area even if it is not profitable (a carrier-of-last-resort obligation closely tied to universal service goals). In return the shareholders receive a commitment that the state will provide them the fair opportunity to recover their invested capital. This quid-pro-quo provided a powerful economic incentive for private capital investment that built the most extensive telephone network in the world. Without a "tax" to provide an explicit subsidy for funding universal service, the loss of the implicit subsidies will remove funds necessary to continue high levels of investment in the infrastructure in rural areas.

D. Competition, Regulation and Public Policy Goals

The Telecommunications Act of 1996 and rapid technological advances are replacing regulation with competition as the primary tool for achieving the public policy goals of: 1) ensuring that telecommunications services are produced and consumed efficiently; and 2) promoting investment and innovation. Thus, regulators on both the federal and state levels need to implement policies that provide efficient, cost-based pricing signals for local exchange and access services to allow market forces to enhance economic efficiency. If basic local and access service prices are set based on costs, competitors will make *technically efficient* investments because the incentives that they receive through market signals (prices) will be based upon cost

[9] On a Federal level, there has been some public funding of the public telephone network (e.g., loans at subsidized interest rates to rural telephone cooperatives), but that accounted for only a small share of the total cost of constructing and operating the telephone network.

and demand. As subsidies from usage sensitive services are removed and prices better reflect costs, customers will consume a mix of services which better satisfies their preferences, promoting *allocative efficiency*. Competition will act as a catalyst to promote investment and innovation because market prices will signal to new entrants where profitable investment opportunities exist. Finally, given appropriate universal service support, ILECs and other carriers-of-last-resort will have the wherewithal to serve high-cost customers and promote *equity objectives*.

Maintaining universal service in a competitive environment will require careful reform of existing policies. In setting new universal service policies, there are a number of guiding principles regulators should use.

- Prices for basic residential service should be kept affordable for all customers with specific, explicit subsidies targeted to low income and high cost rural customers.

- Service providers should receive enough support to cover the costs of providing high quality and reliable service to all customers.

- The universal service funding scheme should be competitively neutral; no telecommunications providers should be unfairly disadvantaged by its design.

- Finally, the system should be stable and transparent, meaning the funding is derived from clearly defined and predictable mechanisms, so that carriers can develop business plans and make investment decisions based on a known set of universal service rules.

IV. LOCAL EXCHANGE SERVICES HAVE DRAMATICALLY INCREASED IN VALUE

When considering fundamental changes in the way local telephone and access services are priced, it is important to assess the affordability and value of these services to consumers. As shown in Figure 1, real prices for local telephone service for consumers in the United States have decreased over the last two decades. Between 1988 and 1997, after adjusting for inflation, the price of telephone service decreased by 15 percent. To the extent that residential service was affordable in the late 1980s, it is even more affordable today relative to other household purchases. During the same time period, the value of local telecommunications services to customers has increased because the quality, reliability and capabilities of the local telephone network have increased dramatically. The local telephone network is a citizen's gateway to numerous complementary services: Internet, FAX, data transmission, toll-free numbers, information services, wireless customers and long distance toll services.

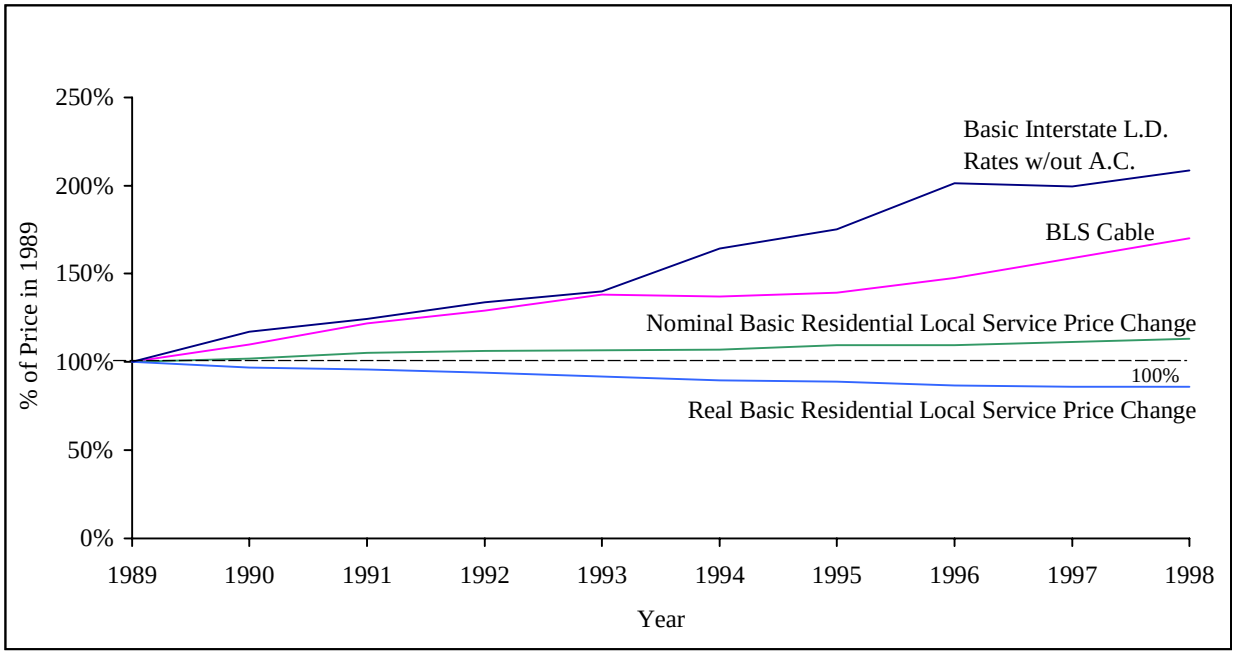
A. Basic Residential Local Exchange Prices

Nominal prices for basic local exchange service have remained stable over time, in part because many prices have been held below cost and cross-subsidized by other services. As shown

in Figure 1, since 1987 nominal prices for local exchange service increased more slowly than the nominal prices of basic cable service or basic long distance service net of access charges.[10] In fact, real prices for local exchange service, as calculated by the Bureau of Labor Statistics, have decreased by 15 percent. This negative growth rate has positive implications for the affordability of local telephone service, even if there is an increase in the subscriber line charge, as proposed in the CALLS plan.

Figure 1.

Nominal Price Indices for Basic Local, Long Distance (w/out access charges) and Cable TV Services



Source: CPI Cable and Local Telephone Indices from Bureau of Labor Statistics web site . Basic Long-distance prices from FCC March 1997 Long Distance Rate Book

B. Technological Advances and Increased Value to Consumers

[10] Figure 1 shows changes in the basic rates paid by customers who do not select discount plans from their long distance carriers. To the extent that changes in discounted prices are out of sync with changes in non-discounted prices, the interstate price curve is only an approximation of the changes in prices actually paid by consumers.

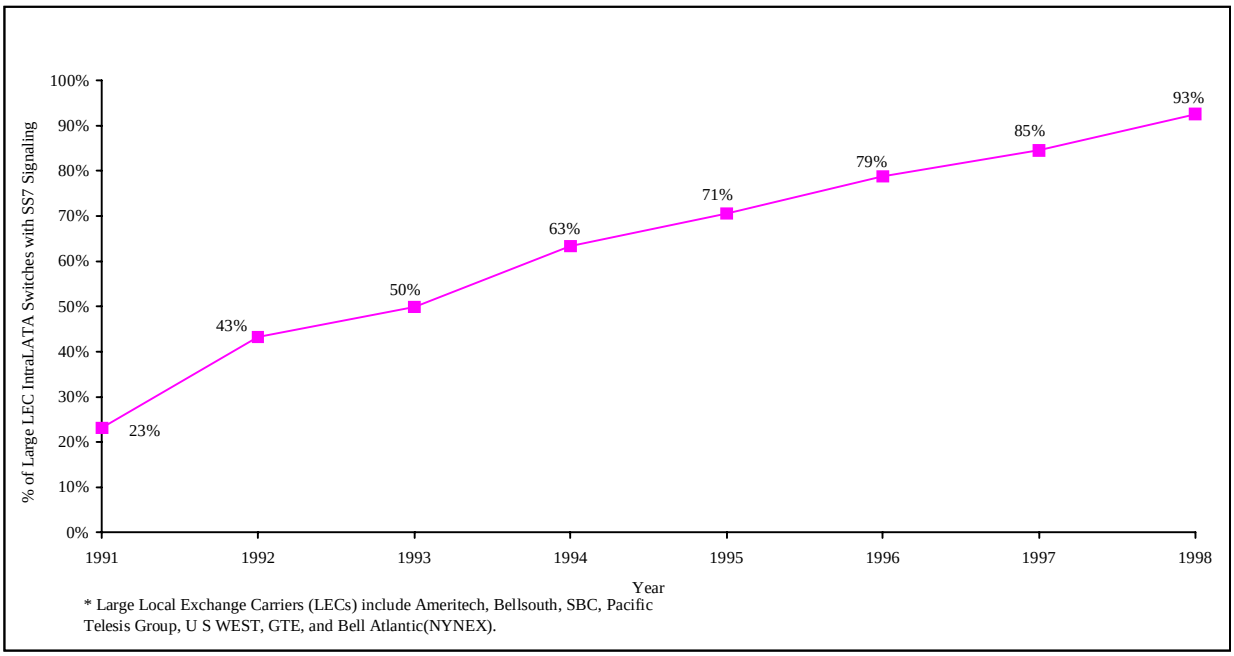
Over the last ten-plus years, a number of new technologies have been integrated into the local exchange network and these technologies have improved the underlying quality, reliability, cost-effectiveness, and functionality of access to the network. These improvements include the deployment of fiber optic transmission facilities, particularly in interoffice transport plant and to a lesser degree in the local loop, improving reliability and functionality and leading to lower costs. Local exchange carriers have also installed digital switches with touch-tone, and advanced signaling capabilities. Digital switches not only improve the quality and reliability of basic services, they also allow telephone companies to offer a wider range of services, such as caller ID, call waiting, call ring back, voice mail and others. And touch-tone services, formerly considered an advanced functionality but now a near ubiquitous basic service, have allowed a wide range of companies - from banks and other financial intermediaries, pharmacies, catalogue retailers and many others - to offer their services electronically via the telephone.

One key advance in local exchange technology within the last 10 years is the pervasive deployment of Signaling System 7 (SS7) technology. In the switch, SS7 provides a protocol for networks and interoffice switches to communicate with each other, speeding call processing and allowing increases in functionality such as fraud detection, 800 number portability and the deployment of new complementary services.[11] Figure 2 shows that SS7 was rapidly deployed in six large incumbent LEC's networks during the 1990s.

Figure 2

Percent of Total IntraLATA Switches
Equipped with SS7 Signaling

[11] *Infrastructure of the Local Operating Companies Aggregated to the Holding Company Level, 1991-95*. Report released March 1997, Federal Communications Commission. (http://www.fcc.gov/Bureaus/Common_Carrier/Reports/FCC-State_Link/infra.html).



Source: "Infrastructure Report 43-07: Switching Equipment," ARMIS Data Retrieval System Federal Communications Commission.

C. Enhanced Complementary Goods and Services

In recent years there has been an explosion in the number, type, and usage of services which are complementary to local telephone service. Over the same time period, prices for these services fell dramatically. This is important because, when two goods are complementary, their joint consumption increases the value of the services to consumers. As new complements to local telephone service become available (or the price of existing complements decreases) consumers are willing to buy new local telephone services and increase the intensity of their use of existing services. For example, in its report, *Digital Tornado*, the FCC cites studies by AT&T, Bellcore, Bell Atlantic, U S WEST and Pacific Bell, that indicate that, while an average voice call lasts 3-5 minutes, Internet users tend to stay on line substantially longer than voice users with estimated hold times of 17-21 minutes.[12] This section provides a brief description of several services that are complementary to basic local service.

a) InterLATA and IntraLATA Long Distance Services

One of the important complementary services to local telephony is long distance service, including switched access, interLATA, and intraLATA toll services. From 1980 to 1997, the portion of all minutes that are long distance minutes grew from 16 percent to 26 percent.[13]

b) Toll Free Calling and Premium Information Services

Another class of services that are complementary to basic local telephone service are the toll free calling (800, 888, 877) services, premium information services (900, 976), and information services. These services are offered by a large number of businesses and government agencies to provide customer support, information, and entertainment services via the telephone.[14] A recent survey estimated that 89 percent of consumers used toll free telephone numbers for customer service needs, making reservations, and ordering or requesting information on products or services.[15] Other common applications include making financial transactions, collect calling, and paying bills. The revenues generated by the toll-free and premium information services market provide an indication of the enormous value generated by these services. In 1997 alone,

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[12] Werbach, Kevin "Digital Tornado: The Internet and Telecommunications Policy" OPP Working Paper Series No. 29, March 1997, pp. 58-59 Office of Plans and Policy, 1919 M Street NW, Washington, DC 20554 http://www.fcc.gov/Bureaus/OPP/working_papers/oppwp29.pdf

[13] "Trends in Telephone Service," FCC Common Carrier Bureau, February 1999, p.12-3.

[14] For example the Federal government offers Medicare referral, Social Security information, veterans affairs, student aid, food and auto safety hotlines, housing and employment discrimination hotlines, postal services, information and reservations for national parks and many other services over toll free numbers.

[15] Staff report (August 17, 1998), *Marketing News*, Marketing Alliances section, p. 2.

interLATA toll-free revenues were over $11 billion, intraLATA toll-free revenues were $290 million, and 900/976 revenues were approximately $1.5 billion.[16]

The growth in the use of toll-free numbers also indicates that consumers value toll free services. The original 800 numbers were depleted in 1996 after nearly 20 years. Given the increased popularity of toll free calling, it took only two years to deplete almost all of the 888 numbers. As of November, 1998, 99+ percent of the total available 800 numbers and 74 percent of the total 888 numbers were in use.[17]

c) Computing, Data Communications, and Applications

Home PC use, Internet access and fax use have experienced dramatic growth in recent years. An increasing number of households now have personal computers with modems and use them to access Internet and online services for telecommuting, education, information, transactions, and entertainment. A large and growing number of households are using the local network to access the Internet. The majority of customers that dial-up for Internet access from home, however, continue to pay the local network provider the same low prices for their basic local service.[18] A recent publication by the FCC cites from a survey that "nearly 80 million Americans are online today, with a total of 100 million Americans expected online by the end of the year 2000."[19] The FCC goes on to observe that,

> "The average cost of basic telephone service is between 13 and 29 dollars per month…Internet service providers offer unlimited dial-up Internet access (no hourly fees) over that inexpensive phone line…Internet service providers themselves utilize this same phone network to offer an amazing array of Internet services to customers, and the

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16 Frost and Sullivan, see DM News, "Increased Competition Equals Growth for Toll Free Market," July 6, 1998.

17 Britt, Phil, "Toll-free help is on the way, But 888 numbers must last a little longer," Telephony Marketing & Services, November 17, 1997.

18 The number of subscribers accessing the Internet with non-dial-up technologies are dwarfed by dial-up subscribers. Jupiter Communications estimates that as of year end 1999 there will be 32 million dial-up households, 1.2 million cable modem households, 0.4 million DSL households, 0.2 million Internet satellite households and 0.5 million ISDN households. See Jupiter Communications, *Consumer Broadband – Last Mile Strategies*, January 1, 1999 (nexius).

19 Oxman, Jason, The FCC and the Unregulation of the Internet, Office of Plans and Policy, Federal Communications Commission, OPP Working Paper no. 31, July 1999, p. 4. The FCC is citing a survey by Intelliquest, cited at Nua Internet Surveys, http://www.nua.ie/surveys/how-many_online/n_america.html.

affordable use of the telephone network has allowed these providers to offer inexpensive access to the Internet to virtually all Americans."[20]

Figure 3 shows current and projected penetration rates for home PCs and Internet access in the United States.

Figure 3

Projected Penetration of PCs and Internet Services in US Households

Source: "ADSL Coalition UAWG Unveiled; List of UAWG Promoters: Cable Modem 1997-2006," in Cable TV Technology (CTT), February 28, 1998, Paul Kagan Associates, Inc.

Although penetration rates for home PCs and Internet access vary greatly based on demographic factors such as income, education level, ethnicity and geography, there is a growing penetration even among traditionally under-served groups. The National Telecommunications and Information Agency released a report entitled *Falling Through the Net II* which analyzed telephone, computer, and Internet penetration across a range of demographic factors. The NTIA

[20] Oxman, Jason, The FCC and the Unregulation of the Internet, Office of Plans and Policy, Federal Communications Commission, OPP Working Paper no. 31, July 1999, p. 5.

report shows that there has been substantial growth in household computer penetration across different ethnic groups.[21] Furthermore, the study shows that even lower income households have achieved significant computer penetration rates.[22]

The home fax machine is another complementary communications device that is increasing the value of local telephone subscription. Fax prices have declined dramatically, spurring their penetration in recent years. An estimated 4.6 million fax machines were used in homes and home offices in 1997, and fax machine sales in this market were expected grow by almost 15 percent annually through the year 2000.[23] Assuming that there are few households with multiple fax machines, this means that approximately 1 household in 20 uses a fax machine.[24]

The array of complementary services is growing apace, as are the penetrations of current complementary services. In sum, the use of these services increases the value of access to telecommunications networks.

V. CALLS PLAN FOR ACCESS CHARGE REFORM

The sections above describe the environment facing regulators and providers of telecommunications services as they consider the steps required to promote continued infrastructure investments and universal service. In this section I summarize my comments on the current environment and describe how the CALLS proposal is a step in the correct direction.

A. General Comments

[21] While the ownership of PCs has grown significantly for minority groups since 1994, white households are still more than twice as likely (40.8%) to own a computer than African-American (19.3%) or Hispanic (19.4%) households. Rates for on-line access are nearly three times as high for Whites (21.2%) as for African-Americans (7.7%) or Hispanics (8.7%). "Falling Through the Net II: New Data on the Digital Divide", NTIA report, 1998, report, http://www.ntia.doc.gov/ntiahome/net2/falling.html and charts http://www.ntia.doc.gov/ntiahome/net2/charts.html.

[22] Overall, the percent of US households with PCs and on-line access increased to 37% and 26%, respectively, as of 1997. Even in households with an annual income between $15,000-19,999, 17% had PCs and 7% had on-line access. "Falling Through the Net II: New Data on the Digital Divide", NTIA report, 1998, report, http://www.ntia.doc.gov/ntiahome/net2/falling.html, and charts http://www.ntia.doc.gov/ntiahome/net2/charts.html.

[23] Faulkner Information Services, "Choosing a Fax Solution," April 1, 1998.

[24] There were 99.7 million U.S. Households in 1997. *Source:* "ADSL Coalition UAWG Unveiled; List of UAWG Promoters: Cable Modem 1997-2006" in *Cable TV Technology* (CTT), February 28, 1998, Paul Kagan Associates, Inc.

The current environment in telecommunications, as it relates to access charges and universal service support, is not conducive to the development of efficient competition, the continued ability of firms to support universal service, or the maintenance of a world class infrastructure that extends to urban and rural customers.

Affordable access to telecommunications networks in rural areas is supported by a pervasive legacy of implicit subsidies, including above cost access prices. In many geographic areas, access prices are well above costs, prices for basic business service are considerably higher than prices for similarly situated residential customers, and prices for urban customers include subsidies for rural customers. Entrants into telecommunications markets and incumbents know that these prices are not sustainable. These prices do not provide the proper signals for entrants to use in their long term business plans, and with increasing local exchange competition, they do not provide the proper wherewithal or incentives for continued investment by incumbents. Moreover, the uncertainty about interstate access prices and the form of future interstate universal service support hampers the development of competition.

On the positive side, the current infrastructure is healthy, telecommunications service is available and affordable to virtually all households, the value that business and residential customers receive from access to telecommunications networks is increasing, and the real price of this service has declined steadily for years. Even without factoring in the remarkable and almost ubiquitous increases in the value of access to telecommunications networks, basic local service has become steadily less expensive relative to the overall price index and the price of other household communications services, such as cable television. Factoring in the increased value of basic telecommunications service, it is clear that there is room for removing some of the need for subsidies targeted at residential service by increasing the overall price of residential service. From a total bill perspective, this is especially true. For many customers across all income groups, increases in monthly subscriber line charges will be offset by decreases in long distance prices.

The needs of maintaining support for universal service and continuing to upgrade rural networks add considerably to the complexity of the transition from regulation to competition in telecommunications. Each year, local exchange carriers invest billions of dollars to upgrade and extend their networks.[25] These investments have increased network quality and reliability with the widespread installation of digital switches, touch-tone and Signaling System 7 (SS7) capabilities, and extensive placement of fiber between local switches. In addition to greater quality and reliability, these investments helped create new services, such as call waiting and caller identification, and they fostered the growth of complementary services, such as touch-tone access to a vast array of information services, from government agencies to pharmacies. Network advances are now bringing high-speed data transport services, such as integrated services digital network (ISDN) and asymmetric digital subscriber line (ADSL), to residential consumers. Going forward, a strong telecommunications infrastructure will depend on continued investments of

[25] According the Statistics of Communications Common Carriers published by the FCC, the combined capital spending on landline telecommunications networks by incumbent local exchange carriers is in excess of $20 billion per year.

billions of dollars per year. To keep these investments on track and ensure that rural networks are not left behind, it is necessary to bring expected revenues in line with costs and provide explicit universal service support. The CALLS plan takes us in the right direction.

In this section I discuss how the CALLS plan furthers the development of efficient and beneficial competition by addressing legacy conditions that are contrary to economic efficiency and providing conditions that support social policy goals incorporated in the overarching goal of universally affordable access to telecommunications networks. For economic efficiency, the goal is to move to cost-based, market driven prices. The CALLS plan will bring access prices more in line with costs, shift some of the support for universal service onto higher residential subscriber line charges, allow for deaveraging of subscriber line charges, make remaining support more explicit, and reduce regulatory uncertainty.

As stated earlier, there are a number of guiding principles for assessing a plan for maintaining universal service support. Prices for basic residential service should be kept affordable with explicit subsidies targeted to low income and high cost rural customers; service providers should receive enough support to cover the costs of providing high quality and reliable service; the funding scheme should be competitively neutral; and funding should be derived from clearly defined and predictable mechanisms so that carriers can develop business plans and make investment decisions based on a known set of universal service rules. The CALLS plan measures well against these principles.

B. Brief Summary of the CALLS Proposal

Important aspects of the CALLS plan for access charge reform and universal service funding are as follows:

1. Reduction of Implicit Subsidies

a) move switched access prices toward costs with a phased-in reduction of access prices;

b) reduce the magnitude of the universal service funding requirement by phasing in higher subscriber line charges (SLCs) for residential customers;

c) reduce the subsidy from business customers to residential customers by reducing the differences among subscriber line charges (SLCs) to residential, small business, and multi-line business customers;

d) simplify charges by combining the presubscribed interexchange carrier (PICC), carrier common line (CCL), and subscriber line charges into one subscriber line charge (SLC);

e) allow for geographic deaveraging of SLCs;

2. Explicit Support and Affordability

a) replace implicit subsidies with an explicit federal universal service support of $650 million per year;

b) maintain affordability of basic telephone service by increasing the amount of lifeline support;

3. Reduction of Regulatory Uncertainty

a) provide incentives for competitive entry in rural areas by making the universal support funding available to entrants that adopt the obligations to serve; and
b) reduce regulatory uncertainty by freezing rates for at least five years after reaching a target price per minute.

C. Discussion of the Provisions of the CALLS Plan

1. Reduction of Implicit Subsidies and Increased Economic Efficiency

The first set of provisions of the CALLS plan listed above call for a reduction of implicit subsidies. Access charges would be reduced toward cost, and to the extent that these reductions are passed through to lower long distance prices, long distance prices paid by all consumers will decline.[26] Moving toward more cost based prices will send the proper signals to consumers and producers and increase allocation, technical, and dynamic efficiency. Lower priced long distance service will decrease the long distance bill for most consumers even as it increases long distance usage. It is also expected that lower switched access prices will curtail inefficient investments that would otherwise be devoted to bypassing switched access with special access. There will be less cream skimming when there is less cream to skim.

Increasing the SLC on residential services will move the overall price of providing residential service closer to cost. This will reduce the size of the universal service fund required to serve rural residential customers, where the cost of providing basic service is often above the price. In many jurisdictions, below cost pricing of basic residential service is not restricted to the most rural areas. Recall that, overall, real prices of basic residential service have been dropping for several years. I will discuss the impact of the increased SLC on residential customers in relation to the affordability of service in the following section.

The plan will also reduce or eliminate the differences among SLC charges to residential, small business, and multi-line business customers. Coupled with the ability to geographically deaverage SLCs, these provisions will reduce the subsidy from business customers to residential customers and from multi-line business customers to residential and single-line business customers. Bringing residential revenues into better alignment with costs will also provide greater incentives for all competitors to serve residential customers.

Overall, these provisions in the CALLS plan will reduce the size of the support required for universal service and lead to prices that are less encumbered with subsidies. To the extent that subsidies are removed from prices and prices more accurately reflect costs, entrants and

[26] In letters filed with the FCC on February 25, 2000, both AT&T and Sprint made commitments to pass through access reductions from the CALLS plan in the form of lower long distance prices. They also agreed to eliminate minimum monthly charges from their basic schedule services.

incumbents will receive more accurate price signals as the basis for their investment decisions. This is an important step in the process to ensure efficient investment in the telecommunications infrastructure, which is the greatest benefit of the CALLS proposal to consumers.

2. Explicit Support and Affordability

Increasing the subscriber line charge will not remove the need to provide universal service funding. There are many areas in this country where the cost of providing basic service will continue to exceed the monthly charges. In these areas, it remains important to have a high cost fund. To this end, the plan will allot $650 million annually to high cost service areas to help offset the loss of implicit subsidies included in today's switched access prices.[27] This amount will be collected as a percent of retail interstate and international retail revenues. The main advantage of this method of universal service support is the fact that it will be explicit and predictable.

Taking this downward trend of the average real price of local residential service into consideration, even for customers who do not make long distance calls, the average increase in the SLC over the next four years will not make basic local service unaffordable. Today, a single-line residential customer pays a SLC of $3.50 per month to their local exchange company. In addition, most single-line residential customers pay their long distance company approximately $1.50 for a pass through of the presubscribed interexchange carrier charge, with an increase in this charge of 50 cents scheduled for July 1, 2000.[28] The sum of these two charges is approximately $5.00 today and will increase to approximately $5.50 in July. Under the CALLS plan, these two charges will be replaced on July 1, 2000 by a SLC of $4.35. A single-line residential customer, therefore, will pay a monthly charge that is $1.15 lower than the sum of the two charges that they will pay otherwise.

Even in later years, when the proposed increases in the SLC cap are completed, the effect on the monthly price will be small. For residential customers the cap on the subscriber line charge will reach a maximum of $6.50 per line by July 1, 2003. It is my understanding that the average residential SLC at that time will be approximately $5.80, or 30 cents higher than the sum of the SLC and PICC amounts that will otherwise be in effect on July 1, 2000. This small increase will do no more than bring the average real price of basic local residential service slightly closer to its level of ten years ago. Recall that the real price of basic residential local service has declined steadily over the past decade. The expected impact of the CALLS plan on the real price of basic residential service through 2003 is depicted in Figure 4.

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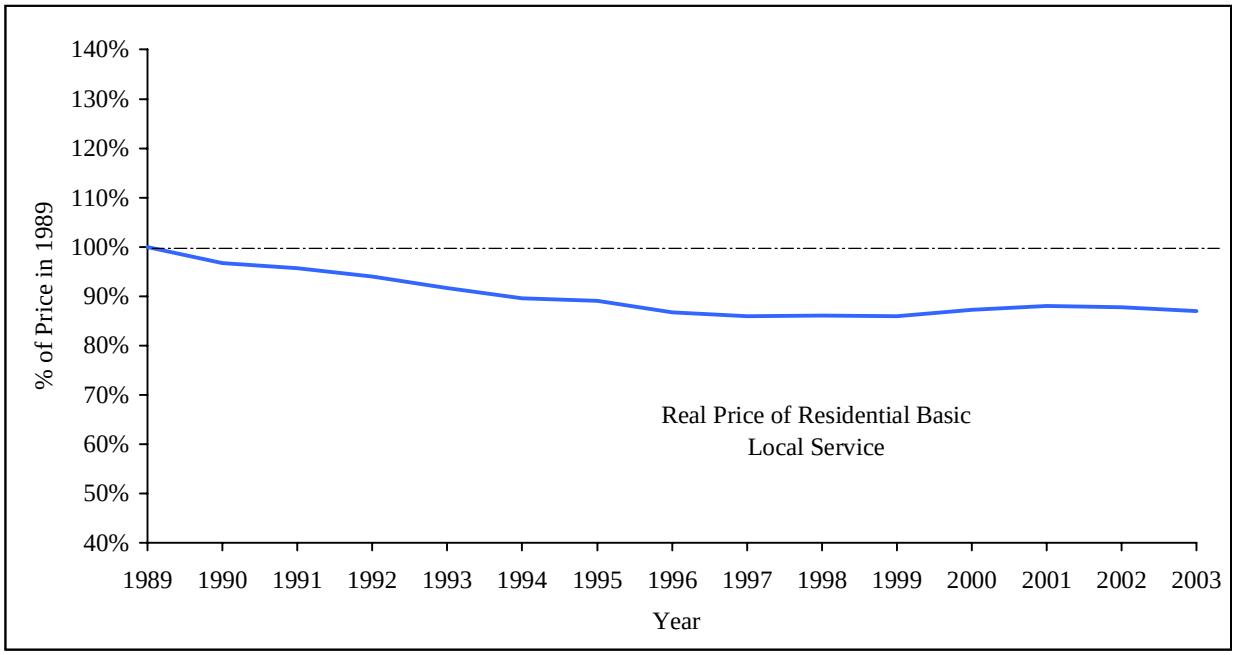
[27] In a number of states it will be necessary to augment this federal universal service funding with state level funding.

[28] For the three largest long distance carriers, the PICC pass through charge is currently $1.51, with an increase of 50 cents scheduled for July 1, 2000.

Figure 4

Real Price Index for Basic Local Residential Service
Including Proposed Increase in SLC Charges



When all local and long distance telecommunications charges are considered, the CALLS proposal is expected to reduce the bills for most consumers. The long distance members of the CALLS coalition have committed to eliminate the monthly minimum charges now imposed on customers who make few calls. Customers who do make long distance calls will benefit directly from price reductions associated with lower access charges. For low income customers, increases in lifeline support will completely offset the increase in the SLC. For these customers, the elimination of the PICC will represent a savings relative to today's charges.

Factoring in the increased value of basic telecommunications service to a wide range of consumers and the decrease in the real price of this service, it is apparent that there is room to lower the amount of money needed to subsidize residential service by increasing the subscriber line charge. Given the labor intensive cost structure used to provide residential access to the network, it may be the case that the charges to more and more residential customers are not covering the cost of service. If this is true, or if competitors and incumbents perceive this to be true, it can have a chilling effect on investments in residential neighborhoods. The reverse is true for the effect of raising the flat-rate charges per month. With prices for residential service that cover the cost of service, incumbents have greater incentives and abilities to maintain investments in high quality service and the deployment of innovative and advanced services, and entrants have greater incentives to enter into competition for residential customers. Portable subsidies and

geographically deaveraged subscriber line charges may well hasten the development of lower cost, high quality wireless alternatives for serving rural customers.

When all of the changes in the CALLS plan are considered, the net effect will be a reduction in the monthly bills for most customers. From the perspective of the affordability of local service, there is no reason to forgo the benefits that the CALLS plan will deliver in terms of improved efficiency and market performance.

3. Reduction of Regulatory Uncertainty

In the transition from a regulated to a competitive industry, decisions by regulators can dramatically affect the outcome of an investment. Because the actual outcome may favor one group of competitors over another, the overall impact of uncertainty is likely to depress investment. Whether an incumbent or entrant is using a sophisticated business plan or intuition to assess the viability of an investment, uncertainty is a cause for concern. When the uncertainty is caused by major revenue and cost drivers, such as access charges and universal service funding, many investment decisions are delayed to await regulatory clarity. There is, therefore, a real cost of regulatory uncertainty. It is wise for regulators to study an issue long enough to come up with a clear and competitively neutral decision, but the cost of delaying a decision until a marginally better decision is derived can easily overwhelm the benefits from such a delay. One advantage of the CALLS plan is that it is relatively straight-forward and clear. Another is that it strives to be competitively neutral.

A competitively neutral policy decision provides equal opportunities for all efficient competitors. The decision to move toward cost-based access charges does not disadvantage competitive providers, even though it will disadvantage firms, such as competitive access providers, that took advantage of subsidy laden prices. Indeed it addresses a competitively non-neutral situation that allowed the possibility that even inefficient competitors could thrive. Portable subsidies provide an example of how the plan strives to be competitively neutral and reduce regulatory uncertainty. By providing the opportunity for entrants to obtain universal service support, the plan provides equal opportunities for all competitors. There are perhaps more efficient technologies available to serve rural customers, such as fixed wireless, that have not been developed due to the below cost pricing in these areas and the uncertainty about the portability of universal service funding. To the extent that the mechanism for collecting and distributing universal service funds is explicit and understandable, it will reduce regulatory uncertainty and promote efficient investments by entrants and incumbents.

VI. CONCLUSION

An important source of consumer benefits from explicit and predictable universal service support is the continued investment in high quality rural telecommunications networks. In the past, regulatory commissions were able to mandate substantial investments by telecommunications providers, even in high cost areas. In return, regulatory commissions guaranteed fair rates of return on overall investments. The mandate to invest and the guarantee to earn a fair rate of

return were mutually dependent. Returns on investments established the wherewithal for the investments and vice versa. Without the wherewithal, the mandate to invest becomes meaningless. You cannot mandate a wingless bird to fly.

An important aspect of the plan proposed by the CALLS is the recognition that access prices and universal service support are intertwined. The public policy goal of universal service established the necessity for funding that led to the legacy of implicit subsidies. To maintain universal service, it is necessary to build new support before, or at the same time that, we unwind the implicit subsidies. Going forward, the investment in high cost areas will rely on explicit and predictable opportunities to earn revenues, including universal support payments, that provide a reasonable return.

The CALLS plan provides a rational transition from subsidy laden access prices toward cost-based prices, and it provides explicit, predictable, and competitively neutral funding for universal service to replace the universal service support that comes from access prices today. Prices for basic residential service will remain affordable, and support will be directed toward the continued development of high quality service in rural areas.

Attachment B

WHY THE PICC WON'T BE "COMPETED AWAY"

Some parties have suggested that, because the long-distance market is perceived as being more competitive than local markets, transferring some interstate loop cost recovery to IXCs, through a PICC charge, will create consumer benefits. They suggest that market pressure will "compete away" the recovery of PICC expenses by IXCs. Based on this supposition, these parties argue that elimination of the PICC, under the CALLS proposal, would somehow shelter ILEC revenue from competition, and deprive consumers of the "benefits" of PICC recovery.[1]

In fact, there are no such benefits. The PICC has proven to be a wasteful and inefficient method of recovery, creating unnecessary costs and confusion. It has impeded the development of competitive local markets. And, three years after its introduction, there is still no sign of its being "competed away."[2] Finally, the Eighth Circuit court has already found that the competitive position of the ILECs is unaffected by whether a portion of loop costs is recovered through the PICC.[3]

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[1] *See, e.g.*, Joint Consumer Commenters at 4: "…its main thrust is to shift costs out of the most competitive rate elements into the least competitive area." *See also* Competition Policy Institute at 1: "the proposal is first and foremost an attempt to shield access revenues of the ILECs by shiftng their recovery to end-user charges."

[2] Vermont agrees (at section IX) that there is no reasonable prospect that PICC charges will be "competed away."

[3] "Whether a LEC allocates all of its loop costs to the end-user or to the IXC, the LEC's comparative position as compared to other suppliers of local exchange facilities remains the same." 153 F.3d 523 (8th Cir. 1998).

1. Competitive firms must recover their costs.

Central to the proposition that PICCs are beneficial is the assumption that competitive firms somehow "forgive" or absorb costs. In fact, the opposite is the case: competitive firms are unable to absorb cost increases, and must pass them along to their customers. There is no such thing as a competitive equilibrium in which firms do not cover their costs.

To an IXC, the PICC charge is an exogenous, or externally given, cost, like a new tax. The IXC cannot reduce this cost by "managing" it better, or by becoming more efficient. Further, it is a predictable, and recurring cost. Sometimes a competitive firm will fail to recover a cost because of changing circumstances. For example, it might invest in new equipment that subsequently becomes less valuable. But a competitive industry will never go on, month after month, failing to recover a recurring, out-of-pocket expense. Since it is the decision to subscribe to local service that triggers the application of the PICC, a customer cannot escape the PICC by changing long distance carriers.[4]

Parties who expect the PICC to be "competed away" appear to assume that competitive firms will somehow take the PICC expense out of their "margins." But competitive firms do not have excess margins, in the sense of extra profits over what is needed to stay in business. In a competitive market, any such margin should have

[4] A customer may escape the PICC by finding an alternative local carrier. This simply reinforces the point, discussed further below, that loop cost recovery can only be affected by local competition, not by long distance competition.

been “competed away” long ago. Adding a new cost or “tax” to a market does not create any new margin that was not there before.

Finally, firms may have “margins” in the sense of a markup over out-of-pocket cost, which covers common costs. Firms manage this margin through a variety of non-linear, or discounted prices. But again, adding a new out-of-pocket cost to the market does not create any new ability to discount that was not there before.

2. PICCs create new costs.

When IXCs set their pass-through charges to recover the PICC, they must recover not only the PICC itself, but also the additional cost of administration, billing expense, and uncollectibles created by handing the charge first from the ILEC to the IXC and then to the end user. These add-on expenses must then be recovered from end users. This is one of the clearest examples of pure waste created by regulation. The PICC is an inefficient way to recover loop cost, and it’s the consumer who must bear the additional cost.

3. The fact is that PICCs have not been “competed away.”

At some point, in order to be useful, any theory has to be confirmed by facts. The simple fact is that PICCs have been in place for three years, and there is not the slightest sign of them being “competed away.” The vast majority of end users pay the PICC charge, either through their IXCs or directly to the ILEC.[5]

[5] The current rules allow a customer to “de-PIC” by not selecting a presubscribed long distance carrier. Customers who select this option are billed the PICC directly by the ILEC, so that the PICC becomes, in effect, a SLC.

There has always been a certain “tooth fairy” aspect to the expectations surrounding the PICC. When the PICC was first implemented, some people suggested that IXCs would not pass the charge through to end users, but would somehow “eat” the expense instead. Of course, this was not possible, and IXCs did pass the PICC through.

It was then suggested that PICC pass-through charges would somehow be “kinder and gentler” to small, low-volume users than would be an equivalent recovery through SLCs. This has not happened either. In fact, the opposite is true. The current PICC cap for primary lines is $1.04; the average PICC pass-through charge of the three largest IXCs is $1.51. This difference is caused, in part, by the new costs discussed above. In part, it reflects the difficulty IXCs have in distinguishing primary lines from non-primary lines.

The current version of the theory is that the PICC will be “competed away.” Three years after the PICC was introduced, the faithful are still waiting for this to happen. It is not clear why it should have taken so long for the expected competitive outcome to happen, or why PICCs should be “competed away” next year, when that has not happened this year.

4. PICCs interfere with customer choice and competition.

Competitive markets work best when they are able to associate the cost caused by a customer’s choice with the choice itself. This allows the customer to “internalize” the cost, considering it fully in choosing to make a given transaction. It also makes it easy to compare different alternatives in the market. Loop costs are caused when

customers decide to purchase services that include loops, such as basic local service.[6] Associating the recovery of the loop cost with this purchase decision allows customers to make informed choices among different providers of local service, and, at the same time, provides local service providers with the correct price signal when making entry and investment decisions.[7]

Competition among IXCs cannot drive cost out of the loop business. Only competition among different providers of loops, or alternative network connections, can do that. IXCs can do nothing to minimize loop costs, and customers cannot escape the cost of their loops by changing IXCs. Therefore, exporting loop cost recovery to an IXC, through a PICC charge, places that recovery in a market where competition among IXCs cannot "compete away" the recovery.[8] In contrast, each local provider can influence the cost of the loops it provides, by becoming more efficient. Further, an end user can affect the cost of his or her local connection by changing local providers.

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[6] The Eighth Circuit has found that the local subscriber "causes" the cost of the loop by making the decision to subscribe. There may be many uses for a given loop, but this is not relevant, since there is only one transaction, and one customer decision, that causes the loop to be provided.

[7] See statement by Dr. Laura Tyson, Attachment A to these reply comments, for a discussion of the importance of loop cost recovery in promoting efficient competition for local service.

[8] Vermont observes "…we are not aware of any basis in the record that would support a conclusion that increasing network efficiencies will allow carriers to forego recovering these charges from customers. The charges are set by the Commission and by the incumbent LEC, and more efficient competition by the IXC cannot reduce them." *See* Vermont Comments at Section IX.

Thus, it is in the local market, and only there, that loop cost recovery can be "competed away."[9]

5. PICC recovery creates a hidden nationwide "pool."

PICCs obscure the customer's choice, not only by exporting part of the loop cost to the long distance bill, but also by spreading that recovery among customers nationwide. For administrative, marketing, and legal reasons, long distance carriers have chosen to average their PICC passthrough charges across the country.

This means, first, that the price signal a customer receives is even less clear. If an end user chooses an ILEC that has high loop costs, the end user will not see the consequences of that choice, because that end user will pay an averaged PICC charge because of rate integration policies. Any CLEC that enters the ILEC's market and operates more efficiently will find it difficult to compete against the ILEC's price, because the CLEC does not benefit from the same averaging mechanism. In effect, the averaging of PICC passthrough charges by IXCs creates a hidden, nationwide pool. Unfortunately, this hidden subsidy flow hinders competition in high cost areas because it is not portable to CLECs, and it also distorts competition in low cost areas by raising prices, but only for ILEC customers.

In contrast, if PICCs are eliminated and replaced by SLCs, as CALLS proposes, then a customer in any given area can make a clear, simple comparison of the charges

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[9] Where local alternatives are available, an IXC might seek to influence customers to choose local providers who do not have PICCs. But this is inherently cumbersome, and it will be difficult for an IXC to communicate to an end user that he or she could get cheaper long distance service by choosing a different local carrier.

that result from choosing either the ILEC or a CLEC as a local service provider in that area.[10] This will promote competition by facilitating informed customer choices.

Given the intensity of the debate over the federal high cost fund, it is curious that more parties have not expressed concern about the fact that the recovery of PICCs by the IXCs acts as a nationwide pooling mechanism, shipping dollars from one state to another. California, for example, has been concerned that it would be a net contributor to the new access universal service fund. In fact, there is today a net outflow of funds from California that dwarfs any effect from the universal service fund. Pacific Bell has a primary PICC today which is below the cap; in the absence of CALLS, this charge is estimated to be just over 60 cents per line. Thus, if CALLS is not adopted, Pacific Bell will charge IXCs 60 cents, and the IXCs in turn will charge each single-line customer a passthrough charge of about $2. The result will be a net outflow from California of about $1.40 for each single-line customer served by Pacific Bell. As the transition built into the current FCC rules proceeds, the flow of funds among states will increase, because PICCs will continue to increase in high cost study areas, even as they are being eliminated in some low cost study areas.[11]

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[10] Iowa agrees (at 4) that "customers do not like the profusion of line items on their bill. A single line charge would be better understood and accepted by customers. It would allow better comparison of the competitive service offerings, both local and long-distance."

[11] Note also that some smaller ILECs have never had a PICC charge, but their customers nonetheless pay the IXC passthrough charge.

6. The PICC charge should be eliminated, and replaced by an SLC.

Debates about end-user charges have always been surrounded by unreasonable expectations. Clearly there is no factual basis for retaining PICC charges in the expectation of creating consumer benefits.

By the end of the five-year CALLS plan, the very idea of distinguishing between local and long-distance service will seem only a distant memory. Vermont itself acknowledges that "the division of loop charges is now pointless" because customers "end up paying the combined total regardless of which carrier ultimately does the billing."[12] The Commission should be guided by what is best for consumers, not by invalid beliefs left over from past debates. The PICC will never be "competed away," but should be replaced—by the reforms proposed in the CALLS plan.

[12] Vermont Comments at Section IX.